Supreme Court, U.S.
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No.

IN THE
Supreme Court of the United States

WALTER A. FORBES and CHRISTOPHER MCLEOD,
Petitioners,

v.

GEORGE SEMERENKO, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

PETITION FOR A WRIT OF CERTIORARI

Of Counsel

STEVEN S. RADIN
SILLS CUMMIS RADIN TISCHMAN EPSTEIN & GROSS, P.A.
One Riverfront Plaza
Newark, NJ 07102
(973) 643-7000

DENNIS J. BLOCK *
HOWARD R. HAWKINS, JR.
CHRISTINE P. JACKSON
STEPHEN CHIPPENDALE
CADWALADER, WICKERSHAM & TAFT
100 Maiden Lane
New York, NY 10038
(212) 504-6000

GREG A. DANILOW
TIMOTHY E. HOEFFNER
WEIL, GOTSHAL & MANGES LLP
767 Fifth Avenue
New York, NY 10153
(212) 310-8000

Counsel for Petitioners Walter A. Forbes and Christopher McLeod

* Counsel of Record

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QUESTION PRESENTED

Whether statements by an issuer concerning its financial condition and business objectives satisfy the "in connection with" requirement for purposes of a claim by a purchaser of an unrelated issuer's stock under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5.

PARTIES TO THE PROCEEDING

The following individuals and entities are parties to the proceeding in the court below:

Cosmo Corigliano, Walter A. Forbes, Christopher McLeod, George Semerenko, E. Kirk Shelton, Cendant Corporation, Ernst & Young LLP, and P. Schoenfeld Asset Management LLC.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners Walter A. Forbes and Christopher McLeod respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Third Circuit (App, *infra*, 1a-39a) is reported at 223 F.3d 165.[1] The opinion of the District Court for the District of New Jersey (App, *infra*, 40a-67a) is reported at 47 F. Supp. 2d 546.

JURISDICTION

The court of appeals entered judgment on June 16, 2000. A petition for rehearing (App, *infra*, 68a) was denied on September 14, 2000. The jurisdiction of this Court rests upon 28 U.S.C. § 1254.

STATUTE AND RULE INVOLVED

The texts of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j)(b) ("Section 10(b)"), and its Rule 10b-5, 17 C.F.R. § 240.10b-5 ("Rule 10b-5"), are reproduced at App, *infra*, 69a.

STATEMENT OF THE CASE

I. The Underlying Litigation

Shortly after the announcement of the termination of a proposed merger between Cendant Corporation ("Cendant") and American Bankers Insurance Group, Inc. ("ABI"),

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[1] The opinion was originally reported at 216 F.3d 315; the opinion reported at 223 F.3d 165 was substituted on August 10, 2000.

Respondents George Semerenko and P. Schoenfeld Asset Management LLC (together "Respondents") filed complaints alleging that Cendant and four of its officers (including Petitioners) had violated Section 10(b) and Rule 10b-5 by making misleading statements about Cendant's financial condition and its intention to consummate the proposed merger.[2] App, *infra*, 2a.

Respondents represent a class of arbitrageurs who purchase shares of companies (such as ABI) involved in merger discussions and then sell the shares on the rising pre-merger market or receive the consideration offered by the acquiring company. *Id.* at 6a. Despite the fact that the proposed merger was conditional by its terms, the gravamen of Respondents' complaints is that statements (including those by Petitioners) about Cendant's financial condition and the proposed merger induced them to purchase ABI stock after the proposed merger was announced. *Id.*

A. Legal Background

Not every misrepresentation involving a security violates the anti-fraud provisions of federal securities law. Section 10(b) and Rule 10b-5 expressly provide that material misrepresentations or omissions are actionable only if made "in connection with" the purchase or sale of a security. Determining the scope of this requirement is critical to important questions about the jurisdiction of federal courts and the reach of the anti-fraud provisions of the federal securities laws.

In *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971), Justice Douglas wrote that the

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[2] P. Schoenfeld Asset Management LLC filed its complaint on October 14, 1998, and George Semerenko filed his complaint (identical but for party information) on November 25, 1998. The Third Circuit consolidated the actions on August 30, 1999.

"in connection with" element requires a plaintiff to show that the alleged fraud "touches" the purchase or sale of the securities. In *Rubin v. United States*, 449 U.S. 424, 429 n.6 (1981), this Court reserved the issue of whether misrepresentations not pertaining to the securities themselves are too light a touch to give rise to a Section 10(b) claim. The Second Circuit, however, answered this question a few years later when Judge Friendly wrote:

> In *Rubin*, the Supreme Court stated that it "need not decide whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves can form the basis of a violation of Sec. 17(a)." We are here compelled to decide that question, with respect to Sec. 10(b) and Rule 10b-5 as well as Sec. 17(a); our answer is negative.

Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984) (footnote omitted).

This conclusion has been followed by some circuits, *e.g.*, *Hunt v. Robinson*, 852 F.2d 786 (4th Cir. 1988), and rejected by others, *e.g.*, *SEC v. Rana Research, Inc.*, 8 F.3d 1358 (9th Cir. 1993). Moreover, "[l]ike the courts of appeals, the nation's district courts are also spread across the board on the 'touching' requirement." *Police Retirement Sys. v. Midwest Inv. Advisory Servs., Inc.*, 706 F. Supp. 708, 715 (E.D. Mo. 1989), *aff'd*, 940 F.2d 351 (8th Cir. 1991). The Third Circuit in this case, as discussed *infra*, has established yet another test for determining when a "touching" satisfies the "in connection with" requirement.

Here, there is no dispute that the plaintiffs did not purchase stock in the defendant corporation and that none of the defendants (including Petitioners) ever made misleading statements about the value of any of the purchased securities. This case therefore presents an ideal opportunity for the Court to resolve a question that continues to confuse the federal

courts, resulting in inconsistent application of the anti-fraud provisions of federal securities law.

B. Factual Background

Petitioners Forbes and McLeod were chairman of the board and vice chairman, respectively, of Cendant Corporation in 1998 when Cendant engaged in merger talks with ABI. App, *infra*, 2a. Following a bidding contest between Cendant and American Insurance Group, on March 23, 1998, Cendant and ABI entered into a merger agreement pursuant to which ABI shareholders would receive Cendant stock or cash for a total of $67 per share for their ABI stock (the "ABI Merger Agreement"). *Id.* at 3a. The ABI Merger Agreement was publicly filed and disseminated to ABI shareholders. *Id.* The agreement contained several termination and abandonment mechanisms. Most significantly, the ABI Merger Agreement expressly provided that it could be terminated and the proposed merger abandoned by mutual consent of the two boards of directors. *Id.* at 42a.

As part of its offer to acquire ABI, Cendant filed a Schedule 14D-1 ("Offer to Purchase") with the Securities and Exchange Commission ("SEC"). *Id.* at 3a.[3] The Offer to Purchase, which was also sent to ABI shareholders, included a statement that "[i]n the opinion of management" the financial information in the offer about Cendant was fairly represented. There is no allegation in the complaints that Petitioners, in fact, thought otherwise. The Offer to Purchase contained no similar statement regarding the financial condition of ABI.[4]

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[3] This Offer to Purchase amended a prior Schedule 14D-1 filed by Cendant during its bidding contest with American Insurance Group. App, *infra*, 41a.

[4] The Offer to Purchase was directed at holders of ABI stock to encourage their participation in the proposed tender offer. It is undisputed

The Offer to Purchase also included a statement that Cendant would obtain funding from various sources, including existing and new credit facilities. *Id.* at 41a. The complaints allege that these statements about Cendant's ability to obtain the necessary financing were false and misleading because Cendant's ability to do so "presumed the truthfulness" of its financial statements. There is no allegation in the complaints, however, that Cendant did not have adequate financing to complete the proposed merger or that Cendant's financing was ever withdrawn.

On April 15, 1998, several weeks after the ABI Merger Agreement was signed and the Offer to Purchase was disseminated to shareholders, Cendant publicly announced that it had discovered certain accounting irregularities and that it might be necessary to restate past earnings. *Id.* at 3a. Cendant also announced that its audit committee would investigate the irregularities. *Id.* On April 27, 1998, Petitioners and the other defendants allegedly caused Cendant to state that it anticipated "[n]o problem in completing the [proposed merger] by late summer." That same day, Petitioner Forbes and another Cendant officer issued a public announcement that "reaffirmed [Cendant's] commitment to completing all pending acquisitions," including that of ABI. *Id.* at 4a-5a. There is no allegation in the complaints that these statements were, in fact, false.

On July 14, 1998, Cendant announced that the accounting irregularities would have a larger impact on its financial statements than previously anticipated. *Id.* at 5a. After this announcement, according to the complaints, the defendants (including Petitioners) publicly affirmed their intention to

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that the tender offer was never completed and that Cendant never purchased a single share of ABI stock. Neither Cendant nor any of its officers had any interest in encouraging purchases or sales of ABI in the open market.

complete the proposed merger with ABI. *Id.* at 42a. There is no allegation in the complaints that Petitioners, in fact, did not believe this statement.

Almost a month later, on August 13, and after Petitioner Forbes had resigned from all positions with Cendant, Cendant announced the completion of its investigation and the delivery of the audit committee's final report to both Cendant's board of directors and the SEC. *Id.* at 5a. Cendant also announced that it would be restating its financial statements for 1995, 1996, and 1997 because of overstatements discovered by the investigation. *Id.* There is no allegation in the complaints that the final audit committee report found that Petitioners knew about the accounting irregularities.

On October 13, 1998, Cendant and ABI jointly announced that the merger agreement and resultant tender offer would be terminated. *Id.* at 6a. The companies effected the termination by entering into a settlement agreement that provided for Cendant to pay a $400 million termination fee to ABI. *Id.* The settlement agreement also expressly provided that "ABI and Cendant believe it is in their respective best interest, and in the best interests of their respective stockholders, that the uncertainty with respect to Cendant's possible acquisition of ABI be resolved as promptly as possible." *Id.* at 42a. Finally, the agreement provided that none of the parties "shall have any liabilities or damages to the other parties thereto for any breach or alleged breach of the [ABI] Merger Agreement, including any willful breach." *Id.*

II. The Proceedings Below

A. The District Court

Shortly after the announcement of the termination, Respondents commenced actions against Cendant and several of its officers (including Petitioners) alleging violations of Section 10(b) and Rule 10b-5. App, *infra*, 6a-7a. The thrust

of Respondents' complaints is that statements made by Cendant and its officers about Cendant's financial condition induced them to purchase not Cendant stock, but rather ABI stock at a price above the fair value of that stock. *Id.* at 6a.

Pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, the district court dismissed the securities fraud claims because the alleged misrepresentations by Cendant were not made "in connection with" any purported class member's purchase of ABI stock. *Id.* at 7a. Describing a "plethora of intermediate steps" between the alleged misrepresentations about Cendant's financial condition and the purchase of allegedly inflated ABI stock, the court deemed the connection too tenuous to satisfy the "in connection with" requirement. *Id.* at 50a. The court also concluded that Respondents could not establish reasonable reliance as a matter of law because it was known to the public at large that the proposed merger was conditional and could be terminated by simple agreement of Cendant and ABI. *Id.* at 52a-56a.

B. The Court Of Appeals

In reversing the district court, the Third Circuit first acknowledged that the "in connection with" requirement can be complicated and stated its intention to "take this opportunity to clarify the standard that governs this matter." App, *infra*, 12a. The court then considered prior Third Circuit precedent. *See Angelastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939 (3d Cir.), *cert. denied*, 474 U.S. 935 (1985); *Ketchum v. Green*, 557 F.2d 1022 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977). The court concluded that beyond noting that a causal connection is required to satisfy the "in connection with" requirement, *Ketchum* and *Angelastro* were not otherwise helpful. App, *infra*, 14a. The Third Circuit therefore looked elsewhere for the proper standard in cases involving the public dissemination of

allegedly misleading information into an efficient securities market.

The Third Circuit turned to decisions in the Second and Ninth Circuits. *See In re Ames Dep't Stores Inc. Stock Litig.*, 991 F.2d 953 (2d Cir. 1993); *McGann v. Ernst & Young*, 102 F.3d 390 (9th Cir. 1996), *cert. denied*, 520 U.S. 1181 (1997). As explained by the court below, these cases hold that if the fraud alleged involves public dissemination of information in a medium upon which an investor presumably would rely, the "in connection with" element may be established simply by proof of materiality of the misrepresentation and the means of its dissemination. App, *infra*, 15a-16a.

The Third Circuit adopted this approach. *Id.* at 16a. Concluding that a standard is needed that recognizes "the realistic causal effect that material misrepresentations, which raise the public's interest in particular securities, tend to have on the investment decision of market participants who trade in those securities," the court held that if the alleged misrepresentations are material, then the "in connection with" requirement "may be satisfied simply by showing that they were publicly disseminated in a medium upon which investors tend to rely." *Id.*

The Third Circuit remanded the case to the district court for further proceedings concerning materiality and public dissemination in light of the newly articulated test. *Id.* at 18a-19a. The court cautioned, however, that the issue of materiality, *i.e.*, whether information altered a stock's price, typically poses a mixed question of law and fact seldom suitable for summary disposition. *Id.* at 19a.

REASONS FOR GRANTING THE PETITION

As the court of appeals openly acknowledged, its decision advanced a new test in the Third Circuit for determining the scope of the anti-fraud provisions of federal securities law. However, its newly minted analysis does not resolve the "in

connection with" controversy; to the contrary, it highlights the deep and long-standing conflict among the circuits regarding the proper test under Supreme Court precedent. This case therefore offers the Court an opportunity to provide guidance on a recurring issue of great significance: When are alleged misrepresentations sufficiently "in connection with" a purchase or sale so as to give rise to a colorable claim under Section 10(b) and Rule 10b-5?

An answer from this Court is warranted because the Third Circuit "has entered a decision in conflict with the decision of another Untied States court of appeals on the same important issue," Sup. Ct. R. 10(a), and it "has decided an important question of federal law that has not been, but should be, settled by this Court." Sup. Ct. R. 10(c). As discussed in greater detail below, the Third Circuit's decision, which conflicts with prior decisions of this Court and the precedents of other circuits, presents an important issue regarding the application of Rule 10b-5, one of the most potent federal securities law regulations.

I. Review Is Warranted Because The Circuits Are Sharply Divided Over The Application Of Supreme Court Precedent

The Third Circuit's expansive interpretation of the "in connection with" requirement conflicts with the approach already adopted by the Fourth and Seventh Circuits (and the Second Circuit in some cases). The more tailored approach of these circuits (and the Third Circuit prior to its decision in this case) recognize only statements regarding the value of a particular security or statements meant to induce a purchase or sale of a security as having been made "in connection with" a purchase or sale for purposes of Section 10(b) and Rule 10b-5. The Third Circuit's new approach has effectively written the "in connection with" requirement out of the statute in fraud-on-the-market cases. Now, according to the

Third Circuit, any statement deemed in hindsight by a judge or jury to be material to the purchaser of *any* security can support a claim under Section 10(b). A clear and irreconcilable conflict on an important issue of federal statutory construction is thus presented.

The circuit split stems from this Court's statement that Section 10(b) and Rule 10b-5 are satisfied where the plaintiff "suffered an injury as a result of deceptive practices *touching* its sale of securities as an investor." *Superintendent of Ins. of State of New York v. Bankers Life & Cas. Co.*, 404 U.S. 6 12-13 (1971) (emphasis added). Simply put, the Third Circuit is the most recent federal court to be confused by this "touching" standard.

This Court has never explained what, exactly, Justice Douglas intended by the term "touching" in the context of Section 10(b) and Rule 10b-5. The closest it has come was footnote four in *United States v. Naftalin*, 441 U.S. 768, 773 n.4 (1979), which noted that *Bankers Life* used interchangeably the terms "in" and "in connection with." Two years later, in *Rubin v. United States*, 449 U.S. 424, 429 n.6 (1981), the Court expressly reserved the question of "whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves can form the basis of a violation of § 17(a) [of the Securities Act of 1933]."[5] The Court has not since addressed the issue. This

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[5] Section 10(b) is the statutory equivalent under the Securities Exchange Act of 1934 of Section 17(a) under the Securities Act of 1933. *See Chemical Bank v. Arthur Andersen & Co.*, 772 F.2d 930, 942 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984) ("Section 10(b) of the 1934 Act was obviously drawn from § 17(a) of the 1933 Act.").

To state a claim under Section 10(b), a plaintiff must plead (i) that the defendant made a misrepresentation or omission; (ii) of a material fact; (iii) that the defendant acted with scienter; (iv) that the plaintiff reasonably relied on the misrepresentation or omission; and (v) the

silence has opened the door to confusion as Section 10(b) litigation has exploded over the past two decades.

The first important application of the "touching" language used in *Bankers Life* is *Chemical Bank v. Arthur Andersen & Co.*, 772 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984). Writing for the Second Circuit, Judge Friendly noted that "[w]e are inclined to agree with Professor Loss, that 'there is no reason to believe that [Justice Douglas's] use of 'touching' was anything more than his variation of 'in connection with' as a matter of literary style." *Id.* at 942 (*citing* Louis Loss, *Fundamentals of Securities Regulation* 903-04 (1983)). The court then held that misrepresentations or omissions must pertain to the securities themselves to satisfy the "in connection with" requirement. *Id.* at 945. This holding reflects the conclusion that

> [t]he purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions — to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be.

Id. at 943.

Chemical Bank thus set forth two criteria for determining whether a "touching" is present: first, the alleged fraud must pertain to the relevant securities purchased or sold or the consideration for them; and second, the fraud must have induced the transaction. This approach has been adopted by both the Fourth and Seventh Circuits. *See Gurwara v. Lyphomed, Inc.*, 937 F.2d 380 (7th Cir. 1991); *Head v. Head*,

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misrepresentation or omission was the cause of the plaintiff's injury. *See In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1417 (3d Cir. 1997).

759 F.2d 1172 (4th Cir. 1985). These circuits (unlike the decision below) reject a "de minimis touch" test that would "make any securities transaction actionable under Rule 10b-5 so long as there [is] some deceptive practice remotely 'touching' the transaction." *Head*, 759 F.2d at 1175.

At the same time, however, this appropriately narrow approach, grounded in *Bankers Life*, has been disregarded by other circuits, even before the decision below. These courts have adopted an expansive interpretation of "in connection with" at odds with the standard described by Judge Friendly. Under this approach, a colorable "touching" arises if *any* nexus exists between the alleged fraud and any securities transaction. *See, e.g., SEC v. Rana Research, Inc.*, 8 F.3d 1358 (9th Cir. 1993) (holding that the "in connection with" requirement is met "if the fraud alleged somehow touches upon or now has some nexus with any securities transaction") (internal quotations omitted).

The Third Circuit now has joined with the Ninth to create a marked division among the circuits. The practical effect of this split is seen in this case. The plaintiffs would have been hard pressed to commence an action in the Fourth Circuit, for example, but would have easily survived a motion to dismiss in the Ninth Circuit.

This dramatic split is not new — its genesis is found in a prepositional phrase that provides little, if any, textual guidance to the meaning of "in connection with." Even a decade ago a scholar surveyed the circuits and concluded that:

> [t]hree distinct lines of reasoning can be found in cases [applying the "in connection with" requirement]. The first holds that a misrepresentation is not in connection with the purchase or sale of securities unless it pertains to the securities themselves. The second modifies the first, allowing a plaintiff to go forward on an allegation of misrepresentation concerning the securities them-

> selves or concerning other matters closely associated with the transactions . . . . [The third] takes an expansive view of 10b-5 and refuses to limit the type of misrepresentation that can be in connection with the purchase or sale of securities.

C. Edward Fletcher, *The "In Connection With" Requirement of Rule 10b-5*, 16 Pepp. L. Rev. 913, 978 (1989).

Nor are these conflicting results confined to the courts of appeal. A startling lack of harmony exists among the district courts, as can be seen even within the Second Circuit in divided opinions over the viability of *Chemical Bank*. *Compare Production Resource Group, L.L.C. v. Stonebridge Partners Equity Fund, L.P.*, 6 F. Supp. 2d 236, 240 (S.D.N.Y. 1998) (holding alleged misrepresentations were not made "in connection with" the purchase of securities because "they did not pertain to the value, nature or investment characteristics of the securities at issue"), *with Aiena v. Olsen*, 69 F. Supp. 2d 521, 536-37 (S.D.N.Y. 1999) (holding alleged misrepresentations related to a securities transaction were actionable under Section 10(b) even though the fraud did not pertain to the value of the securities themselves).

Almost thirty years have passed since Justice Douglas introduced the "touching" standard in *Bankers Life*, and nearly two decades have passed since the *Rubin* Court reserved for another day whether the alleged misrepresentations must touch the securities themselves. That day should be now. The lower courts remain confused and divided, a division that the Third Circuit's newly announced test will further deepen. Time has not reconciled the conflicting views. The Court should bring much needed certainty and uniformity to application of this key element of Section 10(b) and Rule 10b-5. *See* Sup. Ct. R. 10(a).

II. Review Is Warranted Because The Third Circuit's New Test Is A Deeply Flawed Answer To An Important, Recurring, And Yet Unsettled Question Of Federal Law

This Court should decide the scope of the "in connection with" requirement of Section 10(b) and Rule 10b-5 because, in its absence, the circuit courts, including most dramatically the Third Circuit in the decision below, have misapplied this powerful federal securities regulation. *See* Sup. Ct. R. 10(c) (including among the considerations supporting review, "a United States court of appeals has decided an important question of federal law that has not been, but should be, settled by this Court").

A determination by this Court on the scope of the "in connection with" requirement of Section 10(b) and Rule 10b-5 is critical because it "concerns when federal jurisdiction is appropriate" and "serves an important filtration function." 8 Louis Loss & Joel Seligman, *Securities Regulation* 3686 (3d ed. 1991). Section 10(b), in fact, often provides the sole jurisdictional basis for state securities fraud claims to be brought in federal court. *See, e.g., Hunt v. Robinson*, 852 F.2d 786, 787 (4th Cir. 1988). The unsettled state of Section 10(b) thus casts a cloud over federal jurisdiction and encourages plaintiffs to engage in unseemly circuit shopping.

The importance of the "in connection with" requirement is further heightened because it is the basis of both federal civil actions (as here) *and* federal criminal prosecutions. The intervention of the SEC as *amicus curiae* in the Third Circuit further highlights the significance of the issue presented in this case, which is an issue equally applicable to SEC enforcement actions.

The "in connection with" requirement of Rule 10b-5 now covers a vast number of transactions, and in all of them courts struggle to distill principles of interpretation and application. The paradigmatic case of a misleading seller and duped buyer

is far from the only type of Rule 10b-5 litigation. *See, e.g., Taylor v. First Union Corp. of S.C.*, 857 F.2d 240 (4th Cir. 1988) (applying the "in connection with" requirement to a corporate power struggle involving the termination of the plaintiff's husband), *cert. denied*, 489 U.S. 1080 (1989).

With the continuing expansion of the national and international securities markets, suits like those of Respondents alleging "fraud on the market," plainly will continue to increase in number as the size of the capital markets further grows. The decision below, which essentially reads the "in connection with" requirement out of the statute in fraud-on-the-market cases, runs the risk of opening the floodgates to litigation based on claims of indirect, secondary, and collateral alleged consequences of statements that were not made "in connection with" the securities bought or sold.

Given the great (and growing) importance of Section 10(b) and Rule 10b-5 to the nation's capital markets, the decision below is even more problematic. The Third Circuit has taken an extreme interpretation of Section 10(b) that casts a net so wide that *everything* involving a statement or omission alleged to be misleading regarding a corporation can be said to "touch" a securities transaction regarding that corporation or even *another* company. Under the newly announced test, the "in connection with" requirement has absolutely no independent significance because a litigant may automatically satisfy it by simply alleging a material misstatement about anything caused the market for an unrelated security to be impacted and accordingly constitutes sufficient basis for a fraud claim by investors in that unrelated security.

Thus, for example, if an officer of United Airlines were to make a misleading public statement about the airline industry generally that contributed to a downturn in that industry, the "in connection with" requirement would permit a purchaser of stock in American Airlines to sue the officer of United

under Section 10(b). The Third Circuit, in short, has cast a blind eye to the dangers it foresaw fifteen years ago:

> We agree that there is a danger in construing the "in connection with" requirement so broadly that virtually any type of misconduct related to a securities transaction even in the most tenuous or tangential way might be claimed to give rise to a federal securities law violation.

Angelastro v. Prudential-Bache Sec., Inc., 764 F.2d 939, 945-46 (3d Cir.), *cert. denied*, 474 U.S. 935 (1985) (noting that the law in the Third Circuit "is not inconsistent with *Chemical Bank*"); *see also Ketchum v. Green*, 557 F.2d 1022, 1027-28 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977) (stressing the "tight linkage" between misrepresentation and transaction in *Bankers Life* and holding that "[w]e do not believe . . . that *Bankers Life* was intended to be so encompassing in its embrace").

The new Third Circuit test jettisons any requirement in a fraud-on-the-market case that the alleged misrepresentation be made for the purpose of inducing a purchase *or* sale *or* that it even relate to the security, let alone to the value of the security being purchased or sold. Standing in its stead is a form of judicial review based on hindsight that captures *any* statement allegedly material to the purchaser of any security. This standard cannot be squared with the "touching" language of *Bankers Life* and is contrary to the plain language of the "in connection with" clause.

This Court has held that Section 10(b) must be interpreted on the plain text of the statute and that courts are not free to adopt policy-based constructions that "add a gloss to the operative language of the statute quite different from its commonly accepted meaning." *Central Bank v. First Interstate Bank*, 511 U.S. 164, 174 (1994). Yet that is precisely how the Third Circuit constructed its newly articulated test. Concluding that the "[t]he purpose underlying § 10(b) and Rule 10b-5" is to ensure full

disclosure of information and "[t]hat [this] purpose is best satisfied by a rule that recognizes the realistic causal effect [of] material misrepresentations," App, *infra*, 16a, the court of appeals added a "gloss" to Section 10(b) that effectively eliminates the "in connection with" requirement. At a time when Congress has *limited* the circumstances in which a securities fraud action can be brought by enacting the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 *et seq.*, the Third Circuit has opened the floodgates to such litigation.

Contra Justice Friendly's opinion in *Chemical Bank* and its progeny, the only "standard" contained in the Third Circuit's newly minted test is an extremely general one requiring no more than materiality plus public dissemination in a reliable medium. This vague test, which improperly subsumes the "in connection with" requirement into the materiality standard, fails to provide any meaningful guidance. By blurring the elements of a Section 10(b) claim, the decision below threatens to create chaos in an already confused area of federal law.

The far-reaching consequences of this test, if not reformulated by this Court, are evident here. As the district court correctly recognized, the statements about Cendant's financial condition bore, at most, only an incidental relationship to Respondents' purchases of ABI stock. App, *infra*, 50a. Accordingly, such statements did not satisfy the "in connection with" requirement, and Respondents' lawsuits were dismissed for failure to state a claim. *Id.* at 52a. Under the Third Circuit's new test, however, there is little doubt that Respondents — and untold numbers of other purchasers and sellers of the stock of one issuer with complaints about generally available market information or information regarding the stock of another issuer — will be permitted to bring suit under Section 10(b) and Rule 10b-5.

The Third Circuit in this case searched the conflicting circuit case law, disregarded its own precedent, and constructed a test that is no test. This Court should grant the petition to resolve the conflict and correct the Third Circuit's error.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

Of Counsel

STEVEN S. RADIN
SILLS CUMMIS RADIN TISCHMAN EPSTEIN & GROSS, P.A.
One Riverfront Plaza
Newark, NJ 07102
(973) 643-7000

DENNIS J. BLOCK *
HOWARD R. HAWKINS, JR.
CHRISTINE P. JACKSON
STEPHEN CHIPPENDALE
CADWALADER, WICKERSHAM & TAFT
100 Maiden Lane
New York, NY 10038
(212) 504-6000

GREG A. DANILOW
TIMOTHY E. HOEFFNER
WEIL, GOTSHAL & MANGES LLP
767 Fifth Avenue
New York, NY 10153
(212) 310-8000

Counsel for Petitioners Walter A. Forbes and Christopher McLeod

* Counsel of Record

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

No. 99-5355/5356

SEMERENKO, *et al.*

v.

CENDANT CORP., *et al.*

March 21, 2000, Argued
June 16, 2000, Filed
August 10, 2000, Amended Opinion Filed

OPINION OF THE COURT

BEFORE: MANSMANN and GREENBERG, *Circuit Judges* and ALARCON, *Senior Circuit Judge.*[*]

ALARCON, *Senior Circuit Judge.*

I

The P. Schoenfeld Asset Management LLC and the class of similarly situated investors (collectively, the "Class") appeal from the order of the district court dismissing their claims for securities fraud pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure. The Class's complaint was filed under § 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5. The complaint also alleged that the individual defendants were liable for the underlying

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[*] The Honorable Arthur L. Alarcon, Senior Judge of the United States Court of Appeals for the Ninth Circuit, sitting by designation.

violations of § 10(b) and Rule 10b-5 as control persons under § 20(a) of the Exchange Act.

We conclude that the complaint alleges sufficient facts to establish the elements of reliance and loss causation, and that the district court applied the incorrect analysis for determining whether the complaint alleges that the purported misrepresentations were made "in connection with" the purchase or the sale of a security. Because the standard that we have articulated for the "in connection with" requirement is different from the one applied by the district court, we vacate the judgment below and remand the matter for further proceedings. Given that we do not resolve whether the dismissal was proper under § 10(b) and Rule 10b-5, we do not address the dismissal of the Class's claim under § 20(a).

II

The Class filed this action against the Cendant Corporation ("Cendant"),[1] its former officers and directors Walter A. Forbes, E. Kirk Shelton, Christopher K. McLeod, and Cosmo Corigliano (the "individual defendants"), and its accountant Ernst & Young LLP ("Ernst & Young") (collectively, the "defendants"). The Class alleges that the defendants violated § 10(b) and Rule 10b-5 by making certain misrepresentations about Cendant during a tender offer for shares of American Bankers Insurance Group, Inc. ("ABI") common stock. The Class consists of persons who purchased shares of ABI common stock during the course of the tender offer. The class period runs from January 27, 1998 to October 13, 1998. The complaint does not allege that any member of the Class purchased securities issued by Cendant, or that any member of the Class tendered shares of ABI common stock to

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[1] Cendant was formed on December 17, 1997 as the surviving entity in a merger between HFS Inc. and CUC International, Inc. In the interests of simplicity, and because the merger predates the class period, we refer to Cendant as including its predecessor organizations.

Cendant. Instead, it alleges that the defendants made certain misrepresentations about Cendant that artificially inflated the price at which the Class purchased their shares of ABI common stock, and that the Class suffered a corresponding loss when those misrepresentations were disclosed to the public and the merger agreement was terminated. In light of the procedural posture of this case, we must assume the truth of the facts alleged in the complaint. *See In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1420 (3d Cir. 1997).

On December 22, 1997, the American International Group, Inc. ("AIG") announced that it would acquire one hundred percent of the outstanding shares of ABI common stock for $47 per share. On January 27, 1998, Cendant made a competing tender offer to purchase the same shares at a price of $58 per share, or a total price of approximately $2.7 billion. In conjunction with its tender offer, Cendant filed with the Securities and Exchange Commission (the "SEC") a Schedule 14D-1 that overstated its income during prior financial reporting periods.

On March 3, 1998, AIG matched Cendant's bid and offered to pay ABI shareholders $58 for each share of outstanding ABI common stock. Cendant eventually raised its bid price to $67 per share. It then executed an agreement to purchase ABI for approximately $3.1 billion, payable in part cash and in part shares of Cendant common stock. Cendant filed an amendment to its Schedule 14D-1 on March 23, 1998 reporting the terms of the merger agreement. Eight days later, Cendant filed a Form 10-K reporting its financial results for the 1997 fiscal year.

After the close of trading on April 15, 1998, Cendant announced that it had discovered potential accounting irregularities, and that its Audit Committee had engaged Willkie, Farr & Gallagher and Arthur Andersen LLP to perform an independent investigation. Cendant also announced that it had retained Deloitte & Touche LLP to

reaudit its financial statements, and that "[i]n accordance with [Statement of Accounting Standards] No. 1, the Company's previously issued financial statements and auditors' reports should not be relied upon." Nevertheless, the April 15, 1998 announcement reported that the irregularities occurred in a single business unit that "accounted for less than one third" of Cendant's net income, and it indicated that Cendant would restate its annual and quarterly earnings for the 1997 fiscal year by $0.11 to $0.13 per share. Immediately after Cendant disclosed the accounting irregularities, the price of ABI common stock dropped from $64-7/8 to $57-3/4, representing an eleven percent decrease from the price at which the shares had been trading.

Following the April 15 announcement, Cendant made several public statements in which it represented that it was committed to completing the merger with ABI notwithstanding the discovery of the accounting irregularities. On April 27, 1998, Walter A. Forbes, the chairman of the board of directors of Cendant, and Henry R. Silverman, the president and the chief executive officer of Cendant, issued a letter to Cendant shareholders, which was published in the financial press. That letter states:

> We are outraged that the apparent misdeeds of a small number of individuals within a limited part of our company has adversely affected the value of your investment—and ours—in Cendant. We are working together diligently to clear this matter up as soon as possible. We fully support the Audit Committee's investigation and continue to believe that the strategic rationale and industrial logic of the HFS/CUC merger that created Cendant is as compelling as ever.
>
> Cendant is strong, highly liquid, and extremely profitable. The vast majority of Cendant's operating businesses and earnings are unaffected and the prospects

for the Company's future growth and success are excellent.

We have reaffirmed our commitment to completing all pending acquisitions: American Bankers, National Parking Corporation and Providian Insurance.

In a press release issued on May 5, 1998, Cendant stated that "over eighty percent of the Company's net income for the first quarter of 1998 came from Cendant business units not impacted by the potential accounting irregularities."

On July 14, 1998, Cendant revealed that the April 15, 1998 announcement anticipating the restatement of its financial results for the 1997 fiscal year was inaccurate, and that the actual reduction in income would be twice as much as previously announced. Cendant further acknowledged that its investigation had uncovered several accounting irregularities that had not previously been disclosed, and that those accounting irregularities affected additional Cendant business units and other fiscal years. Cendant estimated that earnings would be reduced by as much as $0.28 per share in 1997. After the July 14, 1998 disclosure, the price of ABI common stock dropped until Cendant issued several public statements indicating that it intended to continue the tender offer and that it was "contractually committed" to completing the ABI merger. Thereafter, the market price of ABI common stock was "buoyed" by Cendant's repeated statements that it was committed to completing the merger.

On August 13, 1998, Cendant issued a press release announcing that its investigation into the accounting irregularities was complete. The release stated that Cendant would restate its earnings by $0.28 per share in 1997, by $0.19 per share in 1996, and by $0.14 per share in 1995. On August 27, 1998, Cendant issued a statement that the board of directors had adopted the audit report. The audit report was publicly filed with the SEC on August 28, 1998, and a copy

was forwarded to the United States Attorney for the District of New Jersey. The report included findings that "fraudulent financial reporting" and other "errors" inflated Cendant's pretax income by approximately $500 million from 1995 to 1997, and that Forbes and Shelton were "among those who must bear responsibility." After the audit report was filed with the SEC, the price of ABI common stock closed at $53-1/2 per share on August 28, 1998 and fell further to a closing price of $51-7/8 per share on August 31, 1998, the first day of trading following the disclosure.

On September 29, 1998, Cendant filed an amended Form 10-K for the 1997 fiscal year announcing that Cendant had actually lost $217.2 million in 1997 rather than earning $55.5 million, as previously reported. That announcement caused the price of ABI common stock to drop further to $43 per share by the close of trading. On October 13, 1998, Cendant and ABI announced that they were terminating the merger agreement, and that Cendant would pay ABI a $400 million dollar break up fee, despite the fact that it was not contractually bound to do so. The termination agreement, which was executed the same day, provided that the termination of the merger would not result in liability on the part of Cendant or ABI, or on the part of any of their directors, officers, employees, agents, legal and financial advisors, or shareholders. In response to the disclosure, the price of ABI common stock dropped to $35-1/2 per share by the end of the day.

On October 14, 1998, the day after Cendant and ABI disclosed the termination of the planned merger, the Class filed a complaint in the United States District Court for the District of New Jersey alleging that Cendant and the individual defendants violated § 10(b) and Rule 10b-5 by making fraudulent misrepresentations concerning Cendant's financial condition, its willingness to complete the tender offer, and its willingness to complete the proposed merger.

The complaint also alleged that the individual defendants were liable for those violations as control persons under § 20(a). The Class subsequently amended its complaint to expand the class period and to name Ernst & Young as an additional defendant in its claims under § 10(b) and Rule 10(b)(5).[2]

The defendants filed a motion to dismiss the Class's complaint pursuant to Rule 12(b)(6) and Rule 9(b) of the Federal Rules of Civil Procedure. The district court granted the motion and entered an order dismissing the complaint under Rule 12(b)(6). In explaining its dismissal order, the district court stated that the complaint failed to establish that the alleged misrepresentations were made "in connection with" the Class's purchases of ABI common stock, that the Class reasonably relied on the purported misrepresentations, and that the Class suffered a loss as the proximate result of the purported misrepresentations. The order also dismissed the Class's § 20(a) claim against the individual defendants on the basis that a claim for control person liability cannot be maintained in the absence of an underlying violation of the Exchange Act. In light of its decision to dismiss the complaint pursuant to Rule 12(b)(6), the district court declined to consider whether the Class's complaint also failed to satisfy the heightened pleading requirements of Rule 9(b).

III

Before we address the merits of the Class's arguments, we must first resolve an important question that concerns our jurisdiction to hear this appeal pursuant to 28 U.S.C. § 1291. In reviewing this matter, it came to our attention that the

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[2] We note that the Class also alleged in its amended complaint that Cendant and the individual defendants violated § 14(e) of the Williams Act by making purported misrepresentations in connection with the tender offer. *See* 15 U.S.C. § 78n(e). We do not discuss that claim, however, because the Class has chosen to abandon it on appeal.

district court did not indicate whether it intended to dismiss all of the Class's claims with or without prejudice. In fact, the order denying the Class's motion for leave to amend suggests that the dismissal was without prejudice inasmuch as it did not foreclose the Class from submitting a second motion for leave to amend with a proposed complaint attached. The order states:

> Plaintiffs have requested leave to amend their complaints if any or all of their claims are dismissed. However, plaintiffs have not detailed the substance of any amendment or presented to the Court a proposed amended complaint. Although plaintiffs no longer have the right to amend their complaints as a matter of course after those complaints have been dismissed, the Court may still permit amendment as a matter of discretion. *Kauffman v. Moss,* 420 F.2d 1270, 1276 (3d Cir.) *cert. denied,* 400 U.S. 846, 91 S. Ct. 93, 27 L. Ed. 2d 84 (1970). However, the Court will not consider plaintiffs' requests until they submit the sought amendment for the Court's review. The present complaints lack legal vitality. Without scrutiny of the proposed amendment, the Court cannot determine whether it, the amendment, would be resuscitable or futile. Plaintiffs' motion for leave to amend is denied.

This court has held that a dismissal without prejudice is not a final and appealable order under § 1291, unless the plaintiff can no longer amend the complaint or unless the plaintiff declares an intention to stand on the complaint as dismissed. *See Nyhuis v. Reno,* 204 F.3d 65, 68 n.2 (3d Cir. 2000); *In re Westinghouse Sec. Litig.,* 90 F.3d 696, 705 (3d Cir. 1996); *Borelli v. City of Reading,* 532 F.2d 950, 951-52 (3d Cir. 1976) (per curiam). The Class did not advise the district court that it could no longer amend its pleadings, or that it had elected to stand on the complaint. Instead, it filed a notice of appeal with this court. In its opening brief, the Class

represented that "[t]his court has jurisdiction over this appeal under 28 U.S.C. § 1291 because the district court's opinion and order dismissed of all claims with respect to all parties without leave to replead."

On March 1, 2000, this court ordered the parties to submit further briefing on the question whether the district court had entered a final, appealable order. In its supplemental brief, the Class indicated that it intended to stand on its complaint for the purposes of our review of whether the dismissal was proper under Rule 12(b)(6), but not for the purposes of our independent review of whether the complaint complied with Rule 9(b). In effect, the Class took the position that it could stand on its complaint to satisfy the final judgment rule and, at the same time, avoid a de novo review of whether the complaint pleads the element of scienter with sufficient particularity.

Our own research indicates that the Class's position is consistent with the law of this circuit. In *Shapiro v. UJB Financial Corp.*, 964 F.2d 272 (3d Cir. 1992), this court recognized that a plaintiff may amend a complaint to comply with the particularity requirements of Rule 9(b) even after the plaintiff stands on the compiaint to invoke the court's appellate jurisdiction under 28 U.S.C. § 1291. In that case, the district court dismissed all of the plaintiffs' claims for securities fraud under Rule 12(b)(6) and, alternatively, dismissed a number of the plaintiffs' claims for failing to plead scienter with the particularity required by Rule 9(b). The district court also granted the plaintiffs leave to file an amended complaint to cure some of the defects identified in its order. *See id.* at 277-78. Rather than filing an amended complaint, however, the plaintiffs formally announced that they would stand on their complaint. *See id.* at 278. On review, this court concluded that the district court incorrectly dismissed several of the plaintiffs' claims pursuant to Rule 12(b)(6). *See id.* at 280-284. Despite the fact that the

plaintiffs had elected to stand on their complaint as dismissed, this court declined to affirm the dismissal under Rule 9(b). *See id.* at 285 & n.14. Instead, it remanded the matter to the district court to grant the plaintiffs leave to amend those claims which were properly dismissed pursuant to Rule 9(b) and to evaluate whether the remaining claims satisfied the rule's heightened pleading requirements. *See id.*

In this matter, the district court did not consider the sufficiency of the allegations under Rule 9(b). "Because we are hesitant to preclude the prosecution of a possibly meritorious claim because of defects in the pleadings," the Class should be "afforded an additional, albeit final opportunity, to conform the pleadings" in the event that its complaint fails to comply with Rule 9(b).[3] *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d at 1435 (quoting *Ross v. A.H. Robins Co.*, 607 F.2d 545, 547 (2d Cir. 1979)). We leave it to the district court, however, to determine, in the first instance, whether such an amendment is required. *See Shapiro*, 964 F.2d at 285 n.14. We hold, consistent with the law of this circuit, that we have jurisdiction to hear the merits of this appeal pursuant to § 1291. *See Shapiro*, 964 F.2d at 278. Our review is limited to the question whether the dismissal was proper under Rule 12(b)(6).

IV

Our review of a district court's decision to grant a motion to dismiss is plenary. *See Weiner v. Quaker Oats Co.*, 129 F.3d 310, 315 (3d Cir. 1997). "A motion to dismiss pursuant to Rule 12(b)(6) may be granted only if, accepting all well pleaded allegations in the complaint as true, and viewing them in the light most favorable to [the] plaintiff, [the] plaintiff is not entitled to relief. The issue is not whether a

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[3] We note that the Class is not free to add new factual allegations to comply with Rule 12(b)(6). *See Shapiro*, 964 F.2d at 284.

plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d at 1420 (quotations and citations omitted). In this case, we may affirm only if it appears that the Class could prove no set of facts that would entitle it to relief. *See Weiner*, 129 F.3d at 315.

Section 10(b) prohibits the "use or employ, in connection with the purchase or sale of any security, . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78j(b). Rule 10b-5, which was promulgated under § 10(b), makes it unlawful for any person "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made in the light of the circumstances under which they were made, not misleading. . . in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5(b). To state a valid claim under Rule 10b-5, a plaintiff must show that the defendant (1) made a misstatement or an omission of a material fact (2) with scienter (3) in connection with the purchase or the sale of a security (4) upon which the plaintiff reasonably relied and (5) that the plaintiff's reliance was the proximate cause of his or her injury. *See Weiner*, 129 F.3d at 315; *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d at 1417.

In the present case, the defendants make numerous arguments to support the dismissal of the Class's complaint pursuant to Rule 12(b)(6). They contend that the district court correctly concluded that the alleged misrepresentations were not made "in connection with" the purchase or the sale of a security. They also suggest that the Class could not have reasonably relied on any of the alleged misrepresentations, and that the alleged misstatements were not the proximate cause of the Class's loss. We address each argument, below, under a separate heading.

A.

We must first decide whether the Class's complaint pleads sufficient facts to satisfy the "in connection with" requirement of § 10(b) and Rule 10b-5. The parties have expressed much disagreement over the standard that this court applies in determining whether an alleged misrepresentation was made "in connection with" the purchase or the sale of a security. The defendants, in varying respects, contend that the alleged misrepresentations must speak directly to the investment value of the security that is bought or sold, and that they must have been made with the specific purpose or objective of influencing an investor's decision. In contrast, the Class and the SEC, as amicus curiae, argue that the "in connection with" requirement is satisfied whenever a misrepresentation is made in a manner that is reasonably calculated to influence the investment decisions of market participants. Recognizing that "the 'in connection with' phrase is not the least difficult aspect of the 10b-5 complex to tie down," we take this opportunity to clarify the standard that governs this matter. *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 942 (2d Cir. 1984) (noting the difficulty in establishing a test for the "in connection with" requirement) (quotations and citations omitted).

In *Ketchum v. Green*, 557 F.2d 1022 (1977), this court considered the question whether certain misrepresentations arising out of an internal contest for the control of a closely held corporation were made "in connection with" the subsequent forced redemption of the losing parties' stock. There, a group of minority shareholders secretly conspired to remove the two majority shareholders from their respective positions as the chairman of the board of directors and as the president of the corporation. *See Ketchum*, 557 F.2d at 1023-24. By misrepresenting their intentions concerning the election of corporate officers, the minority shareholders were able to persuade the majority shareholders to elect them to a

majority of the seats on the board of directors. *See id.* After gaining control of the board of directors, the minority shareholders immediately voted to remove the two majority shareholders from their officerships. *See id.* To entrench themselves, they also passed resolutions terminating the majority shareholders' employment and authorizing the mandatory repurchase of the majority shareholders' stock pursuant to a stock retirement agreement. The majority shareholders brought an action pursuant to § 10(b) and Rule 10b-5 to enjoin their ouster from the corporation and to obtain damages. *See id.* at 1024. On review, this court held that the majority shareholders failed to establish that the complained of misrepresentations were made "in connection with" the purchase or the sale of a security. *See id.* at 1027-29. In addition to noting that the case fell within an "internal corporate mismanagement" exception to § 10(b) and Rule 10b-5, the court reasoned that the degree of proximity between the claimed fraud and the securities transaction was simply too attenuated for the case to fall within the scope of the federal securities laws. *See id.* at 1028-29.

This court again considered the contours of the "in connection with" requirement in *Angelastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939 (3d Cir. 1985), when it addressed the question whether a brokerage firm could be held liable under § 10(b) and Rule 10b-5 for making misrepresentations concerning the terms of its margin accounts. In that case, a class of investors sued a national brokerage firm for misrepresenting both the specific interest rates that it would charge in connection with a margin purchase and the formula that it would apply in calculating those rates. *See Angelastro*, 764 F.2d at 941. The district court dismissed the investors' complaint on the basis that the alleged misrepresentations were not made "in connection with" the purchase or the sale of a security. *See id.* This court reversed, holding that the investors could pursue their claims under § 10(b) and Rule 10b-5. The court reasoned that

the requisite causal connection was satisfied by the brokerage firm's fraudulent course of dealing, notwithstanding the fact that the alleged misrepresentations did not relate to the merits of a security. *See id.* at 944-45. In holding in favor of the class, the court specifically noted that "Rule 10b-5 also encompasses misrepresentations beyond those implicating the investment value of a particular security." *Id.*

While the decisions in *Ketchum* and *Angelastro* are illustrative of the point that the "in connection with" language requires a causal connection between the claimed fraud and the purchase or the sale of a security, and that the misrepresentations need not refer to a particular security, they are not helpful in applying the standard to the facts of this case. This case does not present a claim based on allegations of internal corporate misconduct arising from a contest for the control of a closely held corporation. *See Ketchum*, 557 F.2d at 1028. Nor does it concern a fraudulent course of dealing by a brokerage firm. *See Angelastro*, 764 F.2d at 944. Rather, it involves the public dissemination of allegedly misleading information into an efficient securities market. In light of the law of this circuit that the scope of the "in connection with" requirement must be determined on a case-by-case basis, we are compelled to look elsewhere in deciding the standard that governs this matter.[4] *See Ketchum*, 557 F.2d at 1027; *Angelastro*, 764 F.2d at 942-43, 945.

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[4] Despite the arguments of the defendants, we do not find the Second Circuit's decision in *Chemical Bank* instructive in the present inquiry. In that case, a corporation misrepresented its financial status to a commercial lender when it pledged the securities of a subsidiary as collateral for a loan. *See Chemical Bank*, 726 F.2d at 944-45. The court held that the misrepresentations were "merely an incident in a transaction not otherwise involving the purchase or sale of securities" and dismissed the lender's action under § 10(b). *Id.* at 944 n.24. As this court has previously pointed out, the "Second Circuit was concerned that every bank loan partially secured by the pledge of stock might fall within the scope of [§] 10(b)." *Angelastro*, 764 F.2d at 946. That concern is not present here,

In resolving the issue before us, we are persuaded by recent decisions in the Second Circuit and the Ninth Circuit that have addressed the scope of the "in connection with" requirement when the alleged fraud involves the public dissemination of false and misleading information. *See In re Ames Dep't Stores Inc. Stock Litig.*, 991 F.2d 953, 956, 965-66 (2d Cir. 1993) (involving the public dissemination of false information in publicly filed offering documents, press releases, and research reports); *McGann v. Ernst & Young*, 102 F.3d 390, 392-93 (9th Cir. 1996) (involving the public dissemination of false information in a publicly filed annual report). Those courts have generally adopted the standard articulated in *Securities & Exch. Comm'n v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (in banc), and applied an objective analysis that considers the alleged misrepresentation in the context in which it was made.[5] They have held that, where the fraud alleged involves the public dissemination of information in a medium upon which an investor would presumably rely, the "in connection with" element may be established by proof of the materiality of the misrepresentation and the means of its dissemination. *See In re Ames Dep't Stores Inc. Stock Litig.*, 991 F.2d at 963, 965; *Securities & Exch. Comm'n v. Rana Research, Inc.*, 8 F.3d 1358, 1362 (9th Cir. 1993); *In re Leslie Fay Cos. Sec. Litig.*, 871 F. Supp. 686, 697 (S.D.N.Y. 1995). Under that standard, it is irrelevant that the misrepresentations were not made for the purpose or the object of influencing the investment decisions of market participants. *See In re Ames Dep't Stores*

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where the alleged fraud involves the public dissemination of allegedly false and misleading statements into an efficient securities market.

[5] Contrary to the suggestions of the individual defendants, this court has adopted the standards articulated in *Texas Gulf Sulphur Co.* for determining whether the statutory requirements of § 10(b) and Rule 10b-5 are satisfied. *See Gottlieb v. Sandia American Corp.*, 452 F.2d 510, 515-16 (3d Cir. 1971) (adopting the *Texas Gulf Sulphur Co.* test as the statutory test for actions arising under § 10(b)).

Inc. Stock Litig., 991 F.2d at 965 (holding that an investor's reliance need not be envisioned to give rise to liability under § 10(b) and Rule 10b-5).

We conclude that the materiality and public dissemination approach should apply in this case. The purpose underlying § 10(b) and Rule 10b-5 is to ensure that investors obtain fair and full disclosure of material facts in connection with their decisions to purchase or sell securities. *See Angelastro*, 764 F.2d at 942. That purpose is best satisfied by a rule that recognizes the realistic causal effect that material misrepresentations, which raise the public's interest in particular securities, tend to have on the investment decisions of market participants who trade in those securities. *See In re Ames Dep't Stores Inc. Stock Litig.*, 991 F.2d at 966. We therefore adopt the reasoning of the Second Circuit and the Ninth Circuit and hold that the Class may establish the "in connection with" element simply by showing that the misrepresentations in question were disseminated to the public in a medium upon which a reasonable investor would rely, and that they were material when disseminated. We also point out that, under the standard which we adopt, the Class is not required to establish that the defendants actually envisioned that members of the Class would rely upon the alleged misrepresentations when making their investment decisions. *See In re Ames Dep't Stores Inc. Stock Litig.*, 991 F.2d at 965; *In re Leslie Fay Cos. Sec. Litig.*, 871 F. Supp. at 697-98. Rather, it must only show that the alleged misrepresentations were reckless. *See In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999) (reaffirming that § 10(b) and Rule 10b-5 cover reckless misrepresentations).

In its petition for rehearing, Ernst & Young contends that the alleged misrepresentations contained in the financial statements and audit reports that it prepared for Cendant should not be deemed to have been made "in connection with" the purchase of ABI common stock unless it was reasonably foreseeable that they would be incorporated in the

tender offer documents. We agree. The Supreme Court has warned that "[a]ny person or entity, including a lawyer, accountant, or bank who employs a manipulative device or makes a material misstatement . . . on which a purchaser relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability are met." *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191, 128 L. Ed. 2d 119, 114 S. Ct. 1439 (1994) (emphasis in original). Because an accountant is blameless where it could not reasonably have foreseen that its representations would be used in the purchase or the sale of securities, however, the Class must also establish that Ernst & Young knew, or that it had reason to know, that Cendant would use its financial statements and audit reports when making the tender offer for shares of ABI common stock. *See McGann*, 102 F.3d at 397 (holding that the "in connection with" requirement was satisfied for the purposes of Rule 12(b)(6) where the plaintiffs "squarely alleged that the [auditor] knew that [its client] would include its audit opinion in a Form 10-K"); *Frymire-Brinati v. KPMG Peat Marwick*, 2 F.3d 183 (7th Cir. 1993) (stating that "[t]o find the 'connection' just because the managers, unbeknownst to the auditors, show the financial statements to some potential investor would abolish the requirement that the defendant's acts occur in connection with the purchase or sale of securities").

We emphasize, though, that it is no defense that the alleged misrepresentations were made in the context of a tender offer and a proposed merger, or that they did not specifically refer to the investment value of the security that was bought or sold. It is well established that information concerning a tender offer or a proposed merger may be material to persons who trade in the securities of the target company, despite the highly contingent nature of both types of transactions. *See Basic Inc. v. Levinson*, 485 U.S. 224, 238-39, 99 L. Ed. 2d 194, 108 S. Ct. 978 (1988) (holding that preliminary merger

discussions may be material even before an agreement-in-principle is reached); *Securities & Exch. Comm'n v. Materia*, 745 F.2d 197, 199 (2d Cir. 1984) (stating that "even a hint of an upcoming tender offer may send the price of the target company's stock soaring"); *Securities & Exch. Comm'n v. Maio*, 51 F.3d 623, 637 (7th Cir. 1995) (holding that undisclosed information concerning a tender offer was sufficiently material to give rise to liability for insider trading under Rule 10b-5 and Rule 14e-3); *Securities & Exch. Comm'n v. Mayhew*, 916 F. Supp. 123, 131 (D. Conn. 1995) (holding that undisclosed information concerning a pending merger was sufficiently material to give rise to liability for insider trading under § 10(b)). It is also settled that § 10(b) and Rule 10b-5 encompass misrepresentations beyond those concerning the investment value of a particular security. *See Angelastro*, 764 F.2d at 942-44 (holding that a brokerage firm may be liable for misrepresenting the terms of a margin account); *cf. Deutschman v. Beneficial Corp.*, 841 F.2d 502, 508 (3d Cir. 1988) (holding that the purchaser of an option contract has standing to seek damages under § 10(b) for misrepresentations concerning the underlying securities). So long as the alleged misrepresentations were material, the "in connection with" requirement may be satisfied simply by showing that they were publicly disseminated in a medium upon which investors tend to rely, and, in the case of Ernst & Young, that it knew or had reason to know that Cendant would use its financial statements and audit reports when making a tender offer for shares of ABI common stock.

We do not resolve, however, whether the "in connection with" requirement is satisfied in the present case. Because the standard that we have set forth is different from the one applied by the district court, and because the parties have not been afforded a full opportunity to brief the issues of materiality and public dissemination, we will remand this matter to allow the district court to consider, in the first instance, the question whether the Class's complaint pleads

sufficient facts to satisfy the requirements of Rule 12(b)(6).[6] We note, however, that the issue of materiality typically presents a mixed question of law and fact, and that the delicate assessment of inferences is generally best left to the trier of fact. *See Shapiro*, 964 F.2d at 281 n.11. The district court should decide the issue of materiality as a matter of law only if the alleged misrepresentations are so clearly and obviously unimportant that reasonable minds could not differ in their answers to the question. *See Weiner*, 129 F.3d at 317; *In re Craftmatic Sec. Litig.*, 890 F.2d 628, 641 (3d Cir. 1989).

B.

We next turn to the question whether the Class's complaint alleges sufficient facts to establish the element of reliance. It is axiomatic that a private action for securities fraud must be dismissed when a plaintiff fails to plead that he or she reasonably and justifiably relied on an alleged misrepresentation. *See Weiner*, 129 F.3d at 315 (setting forth reliance as an element of a private right of action under § 10(b) and Rule 10-5); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d at 1417 (same). The defendants claim that the complaint fails to establish the element of reliance, because it alleges that the defendants' misrepresentations were made in the context of a tender offer and a proposed merger, that AIG made a competing tender offer to purchase shares of ABI common

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[6] The parties' briefs consider whether it was reasonable for the Class to rely on some of the defendants' statements. On remand, the parties are bound by our holding with respect to those statements inasmuch as it addresses the issue of materiality. *See In re Trump Casino Sec. Litig.*, 7 F.3d 357, 371 (3d Cir. 1993) (applying the bespeaks caution doctrine in the context of materiality). They are otherwise free to renew their motions and make any other arguments concerning the question of materiality as they see fit. *See In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1248 n.16 (3d Cir. 1989). We note that, in the context of an efficient market, "the concept of materiality translates into information that alters the price of the firm's stock." *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d at 1425.

stock at $58 per share, and that Cendant issued a press release on April 15, 1998 warning investors not to rely on its prior representations concerning its financial condition.

Traditionally, purchasers and sellers of securities were required to establish that they were aware of, and directly misled by, an alleged misrepresentation to state a claim for securities fraud under § 10(b) and Rule 10b-5. *See Peil v. Speiser*, 806 F.2d 1154, 1160 (3d Cir. 1986) (discussing theories of reliance). Recognizing that the requirement of showing direct reliance presents an unreasonable evidentiary burden in a securities market where face-to-face transactions are rare and where lawsuits are brought by classes of investors, however, this court has adopted a rule that creates a presumption of reliance in certain cases. *See id.* Under the fraud on the market theory, a plaintiff in a securities action is generally entitled to a rebuttable presumption of reliance if he or she purchased or sold securities in an efficient market. *See In re Burlington Coat Factory Sec. Litig.*, 114 F.3d at 1419 n.8 (holding that a purchaser of securities in an open and developed market is entitled to a presumption of reliance).

The fraud on the market theory of reliance is, in essence, a theory of indirect actual reliance under which a plaintiff is entitled to three separate presumptions in attempting to establish the element of direct reliance. *See Zlotnick v. Tie Communications*, 836 F.2d 818, 822 (3d Cir. 1988). Under the fraud on the market theory of reliance, the court presumes (1) that the market price of the security actually incorporated the alleged misrepresentations, (2) that the plaintiff actually relied on the market price of the security as an indicator of its value, and (3) that the plaintiff acted reasonably in relying on the market price of the security. *See id.* The fraud on the market theory of reliance, however, creates only a presumption, which a defendant may rebut by raising any defense to actual reliance. *See Basic, Inc.*, 485 U.S. at 248-49. This court has pointed out that the presumption of reliance

may be rebutted by showing that the market did not respond to the alleged misrepresentations, or that the plaintiff did not actually rely on the market price when making his or her investment decision.[7] *See Zlotnik*, 836 F.2d at 822; *Peil*, 806 F.2d at 1161. This court has also held that a defendant may defeat the presumption of reliance by showing that the plaintiff's reliance on the market price was actually unreasonable.[8] *See Zlotnik*, 836 F.2d at 822; *Peil*, 806 F.2d at 1161.

In the present case, we are persuaded that the Class has sufficiently pleaded the element of reliance to withstand a challenge under Rule 12(b)(6) with respect to at least some of the alleged misrepresentations. The complaint alleges that ABI common stock traded in an open and developed market throughout the class period, that the market price of ABI common stock incorporated the alleged misrepresentations,[9]

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[7] To rebut the presumption of reliance, a defendant may show that the misrepresentations were immaterial, that the market was aware that the misrepresentations were false, or that the misrepresentations were otherwise not assimilated into the price of the security. Of course, the defendant may also rebut the presumption by showing that the investor would have purchased or sold the securities at that price even with full knowledge of the misrepresentation, that the investor traded in the securities based on an actual belief that the market price was inaccurate, or that the investor's decision to trade was based on some factor other than the market price. *See Basic, Inc.*, 485 U.S. at 248; *Zlotnik*, 836 F.2d at 822; *Peil*, 806 F.2d at 1161.

[8] To establish that an investor's reliance was unreasonable, a defendant may show that the investor knew, or had reason to know, that the misrepresentations were in fact false. *See Zlotnik*, 836 F.2d at 822; *Peil*, 806 F.2d at 1161.

[9] The market assimilates information concerning the possibility of a tender offer or a merger, and the amount of consideration that will be received, into the price of the securities of a target corporation. *See* Frank L. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1164 (1981). "The value of any stock can be understood as the sum of two components: the price that will prevail in the market if there is no

and that the Class members purchased shares of ABI common stock in reliance on that price. The complaint also states that the Class was directly misled by the alleged misrepresentations. Those allegations, if true, are sufficient to establish direct reliance and to create a presumption of indirect actual reliance so long as the Class's reliance on the purported misrepresentations or the market price of ABI common stock was not unreasonable as a matter of law.

We conclude that it was reasonable for the Class members who purchased shares prior to March 3, 1998 to rely on the alleged misrepresentations occurring prior to that date. The defendants have not provided us with a legitimate reason for us to conclude to the contrary. Their arguments concern only the reasonableness of the reliance of the Class members who purchased shares of ABI common stock after March 3, 1998. They have no bearing on the investment decisions of persons who purchased shares of ABI common stock prior to that date, because the reasonableness of reliance is determined at the time of the transaction in question. *See Hayes v. Gross*, 982 F.2d 104, 107 (3d Cir. 1992) (requiring an investor to rely on an alleged misrepresentation at the time of the purchase or the sale of securities); *Zlotnik*, 836 F.2d at 823 (same); *Gannon v. Continental Ins. Co.*, 920 F. Supp. 566, 578 (D.N.J. 1996) (holding that an investor cannot rely on statements that are made subsequent to the purchase of securities).

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successful offer (multiplied by the likelihood that there will be none) and the price that will be paid in a future tender offer (multiplied by the likelihood that some offer will succeed)." *Id.* In this case, the defendants' misrepresentations were incorporated into the price of ABI common stock inasmuch as they spoke to the likelihood that the tender offer and the proposed merger would be successful, or to the extent that they related to the investment value of the Cendant shares that members of the Class were to receive in consideration for tendering their shares of ABI common stock.

To the extent that the defendant's arguments suggest that it is unreasonable as a matter of law to rely on information concerning a tender offer or a merger before the transaction is finalized, we disagree. The Supreme Court has cautioned that "no particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material." *Basic, Inc.*, 485 U.S. at 239. And, other courts have similarly held that information concerning a tender offer may be material while the transaction is still in the planning stage. *Maio*, 51 F.3d at 637; *Mayhew*, 916 F. Supp. at 131. If it may be reasonable for an investor to find information concerning a tentative tender offer or a merger important when making an investment decision, we see no reason why the conditional nature of those transactions should necessarily prevent the investor from reasonably relying on that information as well. *See* 2 Thomas Lee Hazen, *The Law of Securities Regulation* § 13.5B, at 527 (3d ed. 1995) (stating that "[t]he reliance requirement is a corollary of materiality").

We are also persuaded that the Class members who purchased shares of ABI common stock between March 3, 1998 and April 15, 1998 alleged sufficient facts to satisfy the element of reliance. With respect to those purchasers, the defendants maintain that AIG's $58 tender offer provided an independent valuation of ABI common stock upon which the Class members directly or indirectly relied. In effect, the defendants suggest that the market did not incorporate the alleged misrepresentations into the price of ABI common stock during the competing tender offer, and that the Class members would have purchased shares of ABI common stock to tender to AIG even if they had known the truth about Cendant. *See Basic, Inc.*, 485 U.S. at 249 (noting that the presumption of indirect actual reliance may be rebutted by showing that the plaintiff would have completed the transaction regardless of the alleged misrepresentations); *Zlotnik*, 836 F.2d at 822 (stating that the presumption of

indirect actual reliance may be rebutted by showing that the market price was not affected by the alleged misrepresentations). While those arguments are facially appealing, we do not find them persuasive given the procedural posture of this case.

In reviewing a motion to dismiss under Rule 12(b)(6), we must accept the allegations of the complaint as true and draw all reasonable inferences in the light most favorable to the plaintiffs. *See Wiener*, 129 F.3d at 315. In this case, the Class's complaint alleges that the market price of ABI common stock was inflated due to the alleged misrepresentations, and it states that the Class purchased "ABI shares believing they would receive $58 per share . . . in a combination of cash and Cendant stock." Though we agree with the defendants that the market price of ABI common stock incorporated information concerning AIG's $58 tender offer, we may not assume for the present purposes that it did not also incorporate information concerning a potential acquisition by Cendant, or that Cendant's tender offer did not have an actual effect on the Class. Indeed, it is likely that the shares of ABI common stock traded at a relative premium during the competing tender offer based on the fact that two purportedly willing and able suitors sought to acquire the company. It is also possible that members of the Class would not have purchased shares of ABI common stock had they been unable to exchange them for shares of Cendant. Because we must assume the truth of the allegations of the complaint, and resolve all competing allegations and inferences in favor of the Class, we agree that the existence of a competing tender offer did not effect the Class's reliance on the defendants' alleged misrepresentations. *See In re Burlington Coat Factory Sec. Litig.*, 114 F.3d at 1420 (stating that a court must credit the allegations of the complaint and not the defendant's responses when resolving conflicting allegations on a motion to dismiss). We also note that the effect of the $58 tender offer would have been limited to those members

of the Class who purchased shares from March 3, 1998, when the tender offer was made, and March 17, 1998, when Cendant raised its bid price to $67 per share.

We agree that the Class has failed to demonstrate that it was reasonable for its members to rely on the defendants' prior financial statements and auditors' reports following the April 15, 1998 disclosure of the accounting irregularities. The complaint states that Cendant disclosed on April 15, 1998 that it had uncovered accounting irregularities, and that it warned investors not to rely on its prior financial statements and auditor's reports when making an investment decision.[10] The complaint further alleges that the common stock of both Cendant and ABI traded in an efficient market, and that the market price of each stock instantly dropped after Cendant issued the warning.[11] In light of the curative nature of the warning statement, and given the instantaneous decline in the market price of both companies' common stock, we conclude that the announcement immediately rendered the prior misrepresentations concerning Cendant's financial condition thereafter immaterial as a matter of law. *See Weiner*, 129 F.3d at 321 (holding that a public statement curing the misleading effect of a prior misrepresentation renders the prior misrepresentation immaterial); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d at 1425 (stating that an efficient

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[10] The April 15, 1998 announcement, which was filed as an exhibit to an amendment to Cendant's Schedule 14D-1, warned:

> In accordance with SAS No. 1, the Company's previously issued financial statements and auditors' reports should not be relied upon. Revised financial statements and auditors' reports will be issued upon completion of the investigations.

[11] The complaint states that the market price of ABI common stock dropped eleven percent, from $64-7/8 to $57-3/4, following the disclosure of the accounting irregularities, and that the market price of Cendant common stock plummeted forty-six percent, from $35-10/16 to $19-1/16, following the disclosure.

market immediately incorporates information into the price of a security); *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 530 (7th Cir. 1985) (dicta) (stating that an investor may not ask a court to focus on a misrepresentation and ignore information that has already been disseminated). Thus, neither the market nor the Class members could have reasonably relied upon Cendant's prior financial statements or its audit reports after April 15, 1998. Because it made no misrepresentations after the curative statement was issued, Ernst & Young may not be held liable to members of the Class who purchased shares of ABI common stock after April 15, 1998.

Nevertheless, we do not accept the defendants' contention that the Class could not have reasonably relied on the alleged misrepresentations that were included in the April 15, 1998 announcement. The Class claims that the April 15, 1998 announcement misrepresented Cendant's financial condition by stating that the company expected to restate its 1997 earnings by $0.11 to $0.13 per share and to reduce its net income prior to restructuring and unusual charges by approximately $100 to $115 million. The defendants claim that the Class was not entitled to rely on those statements or on any subsequent statements, because the announcement warned that the representations were subject to "known and unknown risks and uncertainties including, but not limited to, the outcome of the Audit Committee's investigation."[12] Their

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[12] We note that the Private Securities Litigation Reform Act's safeharbor for forward-looking statements does not apply in this case. *See* 15 U.S.C. § 78u-5(i)(A)-(B). The alleged misrepresentations were made in conjunction with a tender offer and were attached as exhibits to Cendant's Schedule 14D-1 and the amendments thereto. The safeharbor expressly states that it is inapplicable to statements made in connection with a tender offer, except "to the extent otherwise specifically provided by rule, regulation, or order of the [SEC]." *Id.* Because the SEC has yet to extend the safeharbor to tender offers by rule, regulation, or order, we do not

argument is based upon both the bespeaks caution doctrine, which renders alleged misrepresentations immaterial, and the common sense principle that investors do not act reasonably in relying on statements that are accompanied by meaningful cautionary language.

The parties disagree as to whether the bespeaks caution doctrine applies to the statements made in the April 15, 1998 announcement that predicted the amount by which Cendant would restate its results for the 1997 year. The Class and the SEC maintain that the "bespeaks caution" doctrine is inapplicable, because the statements related to present and historical facts that were capable of verification and, as such, not forward-looking. *See Grossman v. Novell, Inc.*, 120 F.3d 1112, 1123 (10th Cir. 1997) (holding that the bespeaks caution doctrine applies only to forward-looking information). The defendants, in contrast, characterize the statements concerning the restatement as forward-looking, and thus subject to the bespeaks caution doctrine, because Cendant had not completed a reaudit when it disclosed the amount of the anticipated restatement. *See Harris v. Ivax Corp.*, 182 F.3d 799, 802-3 (11th Cir. 1999) (holding that statements made on the last day of a quarter concerning the results for the quarter are forward-looking).

We need not decide whether the alleged misrepresentations in the April 15, 1998 announcement were forward-looking statements, however, because we conclude that the accompanying warnings were not sufficiently cautionary to warn against the danger of relying on the specific numbers identified in the announcement. In *In re Trump Casino Sec. Litig.*, 7 F.3d 357, 369 (3d Cir. 1993), this court instructed that cautionary language must be "extensive yet specific" to

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discuss the defendants' contentions that their statements were also protected under the safeharbor.

prevent a reasonable investor from relying on specific projections. There, the court explained:

> a vague or blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation. To suffice, the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge.

Id. at 371-72. In *Kline v. First Western Gov't Sec., Inc.*, 24 F.3d 480, 489 (3d Cir. 1994), this court clarified that "*Trump* requires that the language bespeaking caution relate directly to that by which plaintiffs claim to have been misled."

In the present case, the cautionary language set forth in the April 15, 1998 announcement generally pertains only to the risk that the results of operations could vary in future fiscal years.[13] In fact, the only risk factor that is apparently

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[13] The cautionary language states, in relevant part:

> Certain matters discussed in the news release are forward-looking statements, as defined in the Private Securities Litigation Reform Act of 1995. Such forward-looking statements are subject to a number of known and unknown risks and uncertainties including, but not limited to, the outcome of the Audit Committee's investigation; uncertainty as to the Company's *future profitability*; the Company's *ability to develop and implement operational and financial systems to manage rapidly growing operations; competition in* the Company's *existing and potential future lines of businesses*; the Company's *ability to integrate and operate successfully acquired businesses* and the risks associated with such businesses; *the Company's growth strategy* and for the Company to operate within the limitations imposed by financing arrangements; uncertainty as to *the future profitability of acquired businesses*; and other factors. Other factors and assumptions not identified above were also involved in the derivation of these forward-looking statements, and the failure of such other assumptions to be realized

applicable to the restatement of Cendant's results for the 1997 fiscal year relates to the risk that the announcement's calculations might differ from those made by the Audit Committee. We are not persuaded that such a general statement of risk is sufficiently substantive and tailored to satisfy the requirements of the bespeaks caution doctrine. *See In re Trump Casino Sec. Litig.*, 7 F.3d at 371-72. Nor are we persuaded that it is adequate to give investors reasonable notice that the projected restatement of Cendant's financial statements should not be trusted so as to make any reliance unreasonable as a matter of law. In our opinion, a reasonable investor may be willing to rely on the announcement's specific calculations concerning the restatement in the absence of a more detailed explanation of the reasons that the calculations might be incorrect and of the effect of any error. The announcement's blanket warning—that the amount of the restatement could later turn out to be wrong—was simply not sufficient to caution reasonable investors against relying on the defendants' representations. *See Kline*, 24 F.3d at 489-90 (holding that cautionary statements in an opinion letter were not sufficiently cautionary to preclude reliance where they suggested nothing more than the possibility that the speaker "might have gotten the law wrong or incorrectly assessed the risk that the IRS would deny deductions"); *see, e.g., Harris*, 182 F.3d at 810, 813-14 (setting forth meaningful and specific cautionary language as an appendix to the opinion). Because we conclude that the alleged misrepresentations concerning the restatement of Cendant's 1997 financial information did not include sufficient cautionary language, we agree that the Class could reasonably rely on the anticipated restatement in the April 15, 1998 announcement. For the same reason, we conclude that the Class members

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as well as other factors may also cause actual results to differ materially from those projected.

(emphasis added).

were not necessarily prevented from reasonably relying on the defendants' subsequent statements concerning Cendant's intent to merge with ABI.

The Class was not entitled, however, to rely indefinitely upon the April 15, 1998 misrepresentations. Cendant announced on July 14, 1998 that it had revised the restatement of its 1997 income, and it disseminated the formal results of the Audit Committee's investigation one month later. We think that it is possible that either, if not both, of those announcements might have cured the effect of the alleged misrepresentations in the April 15, 1998 announcement and rendered the disclosure thereafter unreliable. However, in light of our decision to remand this case, and given that the parties have not discussed the issue, we leave it for the district court to decide in the first instance the point at which the particular misrepresentations could no longer be trusted.

C.

Finally, we must decide whether the Class's complaint adequately pleads the element of loss causation. The defendants contend that the complaint failed to allege sufficient facts to support an inference that the alleged misrepresentations were the proximate cause of the Class's loss. They maintain that the complaint shows that several intervening events, and not the alleged misrepresentations, led first to the artificial inflation and then to the decline in the market price of ABI common stock. In particular, they assert that the price of ABI common stock was inflated by AIG's $58 tender offer and by the approval of the merger agreement by the board of directors of ABI. They also suggest that the Class's loss was actually caused by the mutual termination of the merger agreement by the board of directors of both ABI and Cendant. We disagree.

In *Scattergood v. Perelman*, 945 F.2d 618, 624 (3d Cir. 1991), this court held that a plaintiff may establish the element of loss causation simply by showing that he or she purchased a security at a market price that was artificially inflated due to a fraudulent misrepresentation. *Id.* In that case, the defendants issued a press release stating that they were considering acquiring the outstanding shares of another company at the prevailing market price. *See id.* at 623. The press release also warned that the defendants had "not yet determined to proceed with such transaction," and it cautioned that there could "be no assurance that [the defendants] will ultimately decide to make such an offer or that the [board of directors of the target corporation] would recommend such an offer to the stockholders." *Id.* Some of the plaintiffs purchased shares of the target company's stock at price below the tender offer price expecting that the stock would be acquired at the tender offer price in the near future. *See id.* at 624. The defendants moved to dismiss the complaint pursuant to Rule 12(b)(6), because the complaint lacked an assertion that "the plaintiffs experienced an economic loss as a proximate result of the alleged Rule 10b-5 violation." *Id.* The district court granted the motion to dismiss, and this court reversed. This court held that "the fair inference of the complaint, if one assumes—as we must—the truth of its allegations, is that the market price paid by the plaintiffs exceeded the value of the stock at the time of purchase based on the facts." *Id.* It reasoned that the dismissal was improper, because the complaint suggested that the price paid exceeded the value that the market would have established for the target company's shares had the truth been known. *See id.* The court expressed no opinion concerning the proper method for measuring the plaintiffs' injury. *See id.* at 624 n.2.

This court reached a similar conclusion in *Hayes v. Gross*, 982 F.2d 104, 107 (3d Cir. 1992). There, an investor filed a class action lawsuit against the directors and officers of a

savings and loan association pursuant to § 10(b) and Rule 10b-5 claiming that the class members were injured when they purchased the association's stock at an inflated price. *See id.* at 105. At the urging of the directors, the officers, and the Resolution Trust Company, the district court dismissed the action for failure to state a claim. *See id.* at 105. This court reversed the dismissal and remanded the matter for further proceedings. It concluded that the class had established the element of reliance, and it expressly found "no merit" in the Resolution Trust Company's contention that the complaint failed to allege the element of loss causation. *See id.* at 107 & n.2. In holding that the complaint stated a claim under § 10(b) and Rule 10b-5, the court explained:

> Plaintiff alleges that defendants knowingly or recklessly made material misrepresentations which inflated the market price for Bell stock, and that he relied on the market price as reflecting Bell's true value. As a result, plaintiff claims to have suffered injury as a stock purchaser.

Id. at 107.

We interpret *Scattergood* and *Hayes* as holding that, where the claimed loss involves the purchase of a security at a price that is inflated due to an alleged misrepresentation, there is a sufficient causal nexus between the loss and the alleged misrepresentation to satisfy the loss causation requirement. *Cf. Sowell v. Butcher & Singer, Inc.*, 926 F.2d 289, 297 (3d Cir. 1991) (stating that the difference between the purchase price and the "true value" of the security at the time of the purchase is the "proper measure of damages to reflect the loss proximately caused by the defendants' deceit") (quoting *Huddleston v. Herman & MacLean*, 640 F.2d 534, 555 (5th Cir. 1981) *modified on other grounds*, 459 U.S. 375, 103 S. Ct. 683, 74 L. Ed. 2d 548 (1983)). We note, however, that those decisions assume that the artificial inflation was actually "lost" due to the alleged fraud. Where the value of

the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to that misrepresentation. In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price. *See Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1345 (9th Cir. 1976) (Sneed, J., concurring) (stating that an investor's proximate losses are limited to those amounts that are attributable to the unrecovered inflation in the purchase price). Because a plaintiff in an action under § 10(b) and Rule 10b-5 must prove that he or she suffered an actual economic loss, we are persuaded that an investor must also establish that the alleged misrepresentations proximately caused the decline in the security's value to satisfy the element of loss causation.

We find the Eleventh Circuit's decision in *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997), instructive of this point. In that case, a group of investors filed a class action lawsuit against Kroger Properties, Inc. ("KPI"), its officers, and its independent accountant pursuant to § 10(b) and Rule 10b-5 when the price of KPI stock dropped following a dividend cut. *See id.* at 1445. Only the suit against the independent accountant proceeded to trial. *See id.* At trial, the investors presented evidence that the independent accounting firm made fraudulent statements which inflated the price at which they purchased KPI stock. *See id.* at 1445-46. It was also shown, however, that the dividend cut and the drop in the price of KPI stock occurred more than one year before the fraud was uncovered, and that the board of directors cut the dividend for reasons unrelated to the alleged fraud. *See id.* at 1445, 1448. The independent accountant moved for judgment as a matter of law, contending that the investors had failed to prove the essential element of loss causation. *See id.* at 1446. The district court

denied the accountant's motion, and the Eleventh Circuit reversed. *See id.* at 1446, 1449. The Eleventh Circuit held that the investors had failed to satisfy the loss causation requirement, because they did not present evidence that the artificial inflation was removed from the market price of KPI stock, thereby causing a loss. *See id.* at 1446. In entering judgment in favor of the accountant, the court noted that the misrepresentations were not discovered until more than one year after the drop in the stock price, and that the investors had not presented any evidence that the cut in dividends, which led to the drop in price, was related to the alleged misrepresentations. *See id.* at 1446-47.

Turning to the complaint at issue in this case, we are persuaded that the Class has alleged sufficient facts to show that the alleged misrepresentations proximately caused the claimed loss. The Class contends that it purchased shares of ABI common stock at a price that was inflated due to the alleged misrepresentations, and that it suffered a loss when the truth was made known and the price of ABI common stock returned to its true value. The complaint states, in relevant part:

> 94. As a result of the Cendant Defendants' fraudulent conduct as alleged herein, the prices at which ABI securities traded were artificially inflated throughout the Class Period. When plaintiff and the other members of the Class purchased their ABI securities, the true value of such securities was substantially lower than the prices paid by plaintiff and the other members of the Class. The market price of ABI common stock declined sharply from its March 23, 1998, $64-7/16 per share closing price, to its September 29, 1998, $43 per share closing price. By October 13, 1998, ABI's closing price dropped to $35-1/2. In ignorance of the materially false and misleading nature of the statements and documents complained of herein, as well as of the adverse,

undisclosed information known to defendants, plaintiff and the other members of the Class relied, to their detriment on such statements and documents, and/or on the integrity of the market, in purchasing their ABI common stock at artificially inflated prices during the Class Period. Had plaintiff and the other members of the Class known the truth, they would not have taken such action.

95. At all relevant times, the misrepresentations and omissions particularized in this Amended Complaint directly or proximately caused, or were a substantial contributing cause of, the damages sustained by plaintiff and the other members of the Class. The misstatements and omissions complained of herein had the effect of creating in the market an unrealistically positive assessment of Cendant, as well as of its financial condition, causing ABI's common stock to be overvalued and artificially inflated at all relevant times. Defendants' false portrayal, during the Class Period, of the Company's operations and prospects, as well as of Cendant's financial condition, resulted in purchases of ABI securities by plaintiff and by the other members of the Class at artificially inflated prices measured by the difference between the market prices and the actual value of such securities at the time of purchase, thus causing the damages complained of herein.

* * *

97. As a direct and proximate result of defendants' aforesaid wrongful conduct during the Class Period, plaintiff and other members of the Class have suffered substantial damages in connection with their purchases of ABI common stock.

The complaint further indicates that the price of ABI common stock was "buoyed" by the defendants alleged misrepresentations, and that it dropped in response to disclosure of the alleged misrepresentations and the termination of the merger agreement. Assuming the truth of those allegations, and taking all reasonable inferences in the light most favorable to the Class, we agree that the Class is entitled to offer evidence to support its claim.

Notwithstanding the allegations of the complaint, however, the defendants maintain that the price of ABI common stock was inflated, not by the alleged misrepresentations, but rather by AIG's $58 tender offer and by the approval of the merger agreement by the board of directors of ABI. We do not agree. The Class period covers persons who purchased shares of ABI common stock prior to both events. For those purchasers, neither the competing tender offer nor the board approval of the merger agreement could have provided an independent valuation that would have inflated the price of ABI common stock.

Nor can we say, for the Class members who purchased shares of ABI common stock after that time, that the announcement of AIG's $58 bid and the approval of the merger agreement were sufficient to destroy the causal connection between the alleged misrepresentations and the artificial inflation in the price of ABI common stock. It is well established that not every intervening event is sufficient to break the chain of causation. *See Rankow v. First Chicago Corp.*, 870 F.2d 356, 367 (7th Cir. 1989) (stating that to allow any intervening change in market conditions not directly caused by the defendant to break the chain of causation and exempt the defendant from liability would eviscerate Rule 10b-5); W. Page Keeton et al., *Prosser & Keeton on the Law of Torts* § 44 (5th ed. 1984) (explaining that proximate causation is not destroyed by every intervening event). So long as the alleged misrepresentations were a substantial cause of the inflation in the price of a security and in its

subsequent decline in value, other contributing forces will not bar recovery. *See Robbins*, 116 F.3d at 1447 n.5. While we are mindful that the defendants may disprove that the Class suffered a loss as a result of the alleged misrepresentations by showing that the misrepresentations were not a substantial factor in setting the price of ABI common stock during the Class period, we disagree that the defendants may do so at this stage of the proceedings. *See In re Burlington Coat Factory Sec. Litig.*, 114 F.3d at 1420 (setting forth the standard for reviewing a motion to dismiss). It is possible that one portion of the inflation was attributable to both the competing tender offer and the board approval of the merger agreement, and that the remaining portion of the inflation was attributable to the alleged misrepresentations. It is equally reasonable to infer that the alleged misrepresentations played a substantial role in the decision of the board of directors of ABI to approve the merger agreement, especially considering the fact that ABI shareholders were to receive Cendant common stock in exchange for their shares of ABI common stock.

We also disagree with the defendants' contention that the mutual termination of the merger agreement was an intervening event that caused the Class's loss. The complaint alleges that the market price of the common stock of both ABI and Cendant declined in response to the alleged fraud. From that allegation, it is reasonable to conclude that the disclosure of the falsity of the alleged misrepresentations played a substantial factor in the termination of the merger agreement. Indeed, it is possible that the board of directors of ABI no longer found it beneficial for its shareholders to exchange shares of ABI common stock for shares of Cendant common stock following the discovery of Cendant's true financial condition. In light of the sharp decline in the price of Cendant common stock, it is also reasonable to infer that the board of directors of Cendant sought to cancel the merger to avoid diluting the shares of its existing shareholders. We

therefore agree with the contentions of the Class and conclude that the complaint alleges sufficient facts to establish the element of loss causation.

CONCLUSION

In sum, we conclude that the complaint alleges sufficient facts to establish the elements of reliance and loss causation. We do not resolve, however, whether the complaint also satisfies the "in connection with" requirement; nor do we consider whether the complaint complies with the heightened pleading requirements of Rule 9(b). Rather, we vacate the judgment of the district court and remand this matter so that the district court may determine, in the first instance, whether the alleged misrepresentations were material and publicly disseminated in a reliable medium and, in the case of Ernst & Young, whether it was reasonably foreseeable that Cendant would use its financial statements and audit reports in its tender offer for shares of ABI common stock.[14] We also

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[14] We find no merit in the defendants' claim that the dismissal should be affirmed on the alternative ground that the complaint fails to allege that the defendants shared a "fiduciary or other similar relation of trust and confidence" with the Class members. The complaint does not allege that the defendants failed to disclose material facts. *See, e.g., Dirks v. Securities & Exch. Comm'n*, 463 U.S. 646, 661, 77 L. Ed. 2d 911, 103 S. Ct. 3255 (1983) (considering whether a tippee was under a duty to disclose inside information or to abstain from trading); *Chiarella v. United States*, 445 U.S. 222, 228, 63 L. Ed. 2d 348, 100 S. Ct. 1108 (1980) (considering whether a financial printer was under a duty to disclose information to shareholders of a corporation for whom he did not work or to abstain from trading in the corporation's securities); *Gordon v. Diagnostek, Inc.*, 812 F. Supp. 57, 60 (E.D. Pa. 1993) (considering whether an acquiring corporation was under a duty to disclose certain financial information to the shareholders of a target corporation); *Lerner v. FNB Rochester Corp.*, 841 F. Supp. 97, 99, 103 (W.D.N.Y. 1993) (considering whether a potential acquirer was under a duty to disclose material information to the shareholders of a target corporation); *Gershon v. Wal-Mart Stores, Inc.*, 901 F. Supp. 128, 129-31 (S.D.N.Y. 1995)

instruct the district court to consider whether the complaint nevertheless should be dismissed for a failure to plead scienter with particularity. Because we do not resolve whether the dismissal was proper under § 10(b) and Rule 10b-5, we do not address the merits of the dismissal of the Class's claim under § 20(a).

(considering whether a corporation was under a duty to disclose to the shareholders of another corporation that it intended to terminate a contract for the sale of goods); *Lindblom v. Mobile Telecomm. Technologies Corp.*, 985 F. Supp. 161, 163 (D.D.C. 1997) (considering whether a subsidiary whose securities were not traded owed a duty to disclose certain information to the shareholders of the parent corporation). Rather, it alleges that the defendants made affirmative misrepresentations. Though defendants who are neither fiduciaries nor insiders generally are not under a duty to disclose material information, they subject themselves to liability under § 10(b) and Rule 10b-5 when they make affirmative misrepresentations. *See Deutschman v. Beneficial Corp.*, 841 F.2d 502, 506 (3d Cir. 1988) (stating that nothing in the law of this circuit "can be construed to require a fiduciary relationship between a section 10(b) defendant and the victim of that defendant's affirmative misrepresentation").

APPENDIX B

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civ. No. 98-4734 (WHW)
Civ. No. 98-5384 (WHW)

P. SCHOENFELD ASSET MANAGEMENT LLC

v.

CENDANT CORP., *et al.*

April 30, 1999, Decided
April 30, 1999, Filed
May 3, 1999, Entered

OPINION:

Walls, District Judge

All defendants move to dismiss plaintiffs' amended complaints for failure to state a claim upon which relief may be granted and plaintiffs move for leave to amend their complaints if any or all of their claims are dismissed. The complaints charge defendants with violations of sections 10(b), 14(e), and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5. The complaints are dismissed because they fail to state a cause of action under the securities laws. Plaintiffs' motion to amend their complaints is denied.

FACTS

Plaintiffs are arbitrageurs who purchased shares of American Bankers Insurance Group, Inc. ("ABI") stock between January 27, 1998 and October 13, 1998 after an announcement by Cendant that it would purchase ABI.[1]

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[1] Cendant was formed on December 17, 1997 before the class period by the merger of HFS Inc. ("HFS") and CUC International, Inc. ("CUC").

Earlier, on December 22, 1997, the American International Group, Inc. ("AIG") and ABI had announced their entry into a merger agreement whereby AIG would acquire 100% of the outstanding stock of ABI for $47 cash per share. Then, on January 27, 1998, Cendant filed a Schedule 14D-1 with the Securities Exchange Commission ("SEC") which included an offer by Season Acquisition Corp., its wholly owned subsidiary, to purchase ABI for a share price of $58 or approximately $2.7 billion. The "offer to purchase" was also sent to ABI shareholders and included information about Cendant's earnings, revenues, and other financial and operational information. Cendant had engaged in a bidding war with AIG, and AIG had also offered to purchase ABI for $58 per share. Finally, on March 23, 1998 Cendant entered into an agreement with ABI to acquire it for $67 per share or approximately $3.1 billion (the "ABI Merger Agreement").

Cendant filed amendments to its 14D-1 Schedule with the SEC on March 23, 1998, May 7, 1998, July 2, 1998, July 27, 1998, September 1, 1998, and October 2, 1998. Plaintiffs contend that the financial statements contained in the original and amended 14D-1 Schedules and the offer to purchase were materially false and misleading. Plaintiffs allege that they purchased ABI stock in reliance on this materially false and misleading information contained in Cendant's offer to purchase, its 14D-1 Schedules, and other documents and press releases related to the tender offer. They maintain that Cendant's false and misleading statements caused the artificial inflation of the price of ABI's shares and that the true value of the securities was substantially lower than the prices they paid. They purchased the stock in the belief that they would receive $58 or $67 per share from Cendant.

On April 15, 1998, after Cendant announced that it had discovered potential accounting irregularities and expected to restate its annual and quarterly earnings for 1997 and possibly earlier periods, ABI shares dropped 11% from $64-7/8 to

$57-3/4. Plaintiffs assert that ABI's stock price fell further after the July 14, 1998 announcement by Cendant that the accounting irregularities would have a larger impact on its financial statements than had been previously anticipated. However, the stock price of ABI "was buoyed by Cendant's repeated public commitment to complete the ABI Merger." (Am. Compl. ¶ 60.) On September 29, 1998, Cendant publicly announced that it had lost $217.2 million in 1997 instead of earning $55.5 million as it had reported earlier. The price of ABI's stock dropped to $43 on that day. Two weeks later, on October 13, 1998, Cendant announced that ABI and it had ended their agreement for the acquisition of ABI; ABI's stock price fell to $35-1/2. (Pl.'s Mem. in Supp. of Mot. at 7.)

According to plaintiffs, Cendant reaffirmed its agreement to buy ABI at the $67 share price on April 27, 1998, May 7, 1998, July 27, 1998, August 31, 1998, and October 2, 1998. (Am. Compl. ¶¶ 55, 57, 62, 78, 81.) Cendant ultimately extended the tender offer date to November 2, 1998, but terminated the offer on October 13, 1998. In their complaints and opposition brief to defendants motions, plaintiffs do not allege that they ever tendered any shares of ABI to Cendant. However, at oral argument plaintiffs' counsel represented, without any support, that 28 million shares of ABI were tendered before Cendant's tender offer was withdrawn, but Cendant did not purchase any of the tendered shares.

The ABI Merger Agreement contained several mechanisms for the termination of the merger. The Agreement expressly provided that it could be terminated and the proposed merger abandoned by mutual consent of the Boards of Directors of Cendant and ABI. (Agreement at § 8.1.) Such termination would result in no liability on the part of any party or any of its directors, officers, employees, agents, legal and financial advisors or shareholders. (*Id.* at § 8.5(a)).

None of plaintiffs' complaints mentions the conditions of the termination of the ABI Merger Agreement. Cendant and ABI entered into a Settlement Agreement, which was filed with the SEC, to effect the termination of the ABI Merger Agreement. Cendant and ABI agreed to release each other, including "their respective affiliates, their respective Representatives and stockholders, and their respective successors and assigns" from any claims related to the proposed acquisition of ABI by Cendant. (Settlement Agreement § 4.) Cendant agreed to pay ABI $400 million cash payment as a break-up fee. (Settlement Agreement § 2.) This break-up fee was announced on October 13, 1998. The Court considers the terms of the Settlement Agreement because that agreement was filed with the SEC as an exhibit to Cendant's quarterly report Form 8-K and Schedule 14D-1 and is a matter of public record.

On October 14, 1998, plaintiffs filed suit in this Court against Cendant and individual defendants. The individual defendants Forbes, McLeod, Shelton, and Corigliano had been officers or directors of Cendant and/or its predecessor, CUC. The additional defendant Ernst & Young LLP ("E&Y") acted as CUC's independent public accountant from 1983 through the formation of Cendant, and afterwards, audited the financial statements of Cendant Membership Services ("CMS"), a wholly owned subsidiary of Cendant, for the year ending December 31, 1997. These financial statements of CMS were consolidated into Cendant's financial statements and included in Cendant's Form 10-K for the 1997 fiscal year, filed with the SEC.[2] Plaintiffs' complaints allege violations of sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5. The class period in the original complaint began March 23, 1998 and ended October 13, 1998. On February 8, 1999, plaintiffs filed an

[2] Section 240.13a-1 of 17 C.F.R. requires publicly held corporations to file an annual report on Form 10-K with the SEC.

amended complaint which re-set the beginning of the class period to January 27, 1998, added another claim, a violation of section 14(e) of the Williams Act, and another defendant, Ernst & Young, LLP. Plaintiffs claim that all the defendants violated § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5, 17 C.F.R. § 240.10b-5, that Cendant and the individual defendants also violated § 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78n(e) (the Williams Act), and that the individual defendants have violated § 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t.

DISCUSSION

A. Motion to Dismiss Standard

On a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6), the court is required to accept as true all allegations in the complaint, and all reasonable inferences that can be drawn therefrom, and to view them in the light most favorable to the non-moving party. *See Oshiver v. Levin, Fishbein, Sedran & Berman,* 38 F.3d 1380, 1384 (3d Cir. 1994). The question is whether the plaintiff can prove any set of facts consistent with his/her allegations that will entitle him/her to relief, not whether that person will ultimately prevail. *Hishon v. King & Spalding,* 467 U.S. 69, 73, 104 S. Ct. 2229, 2232, 81 L. Ed. 2d 59 (1984). While a court will accept well-pleaded allegations as true for the purposes of the motion, it will not accept legal or unsupported conclusions, unwarranted inferences, or sweeping legal conclusions cast in the form of factual allegation. *See Miree v. DeKalb County, Ga.*, 433 U.S. 25, 27 n.2, 97 S. Ct. 2490, 2492 n.2, 53 L. Ed. 2d 557 (1977); *Washington Legal Found. v. Massachusetts Bar Found.*, 993 F.2d 962, 971 (1st Cir.1993); *Violanti v. Emery Worldwide A-CF Co.*, 847 F. Supp. 1251, 1255 (M.D.Pa.1994). Moreover, the claimant must set forth sufficient information to outline the elements of his claims or to permit inferences to be drawn that these elements exist. *See*

Fed.R.Civ.P. 8(a)(2); *Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S. Ct. 99, 101-102, 2 L. Ed. 2d 80 (1957). The Court may consider the allegations of the complaint, as well as documents attached to or specifically referenced in the complaint, and matters of public record. *See Pittsburgh v. West Penn Power Co.*, 147 F.3d 256, 259 (3d Cir. 1998); *see also* 5A Charles A. Wright & Arther R. Miller, *Federal Practice & Procedure* § 1357 at 299 (2d ed. 1990).

B. Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), prohibits the use of fraudulent schemes or devices in connection with the purchase or sale of securities. Under § 10(b), it is unlawful to "employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention" of any rule promulgated by the SEC designed to protect the investing public. To implement the statute, the SEC enacted Rule 10b-5, violation of which gives rise to a private cause of action. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S. Ct. 1917, 44 L. Ed. 2d 539 (1975). That Rule, in turn, deems it unlawful: (1) "To employ any device, scheme, or artifice to defraud," (2) "[t]o make any untrue statement of a material fact" or to omit to state a material fact so that the statements made "in light of the circumstances," are misleading, and (3) "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. § 240.10b-5. The Supreme Court has held that standing to bring a private cause of action under Rule 10b-5 is limited to actual purchasers or sellers of securities. *Blue Chip Stamps*, 421 U.S. 723, 95 S. Ct. 1917, 44 L. Ed. 2d 539.

This tort, although statutory in origin, sounds in the common law of fraud and deceit and retains, in modified

form, the common law elements of duty, breach, causation, and damage. *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 547 (5th Cir.1981) (10b-5 claim derived from common law action for deceit), *modified on other grounds*, 459 U.S. 375, 103 S. Ct. 683, 74 L. Ed. 2d 548 (1983). The plaintiff must prove knowledge by the defendant, an intent to defraud, misrepresentation or failure to disclose, materiality of the information and, injurious reliance by the plaintiff. *Thomas v. Duralite Co.*, 524 F.2d 577 (3d Cir. 1975); *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402 (3d Cir.), *cert. denied*, 425 U.S. 993, 96 S. Ct. 2205, 48 L. Ed. 2d 817 (1976). More precisely, these elements form the following test. To make a 10b-5 claim, a plaintiff must allege that the defendant made (1) a misstatement or an omission (2) of a material fact (3) with scienter (knowledge) (4) in connection with the purchase or sale of a security (5) upon which plaintiff reasonably relied, and (6) that reliance proximately caused injury to the plaintiff. *Kline v. First Western Government Securities, Inc.*, 24 F.3d 480, 487 (3d Cir.), *cert. denied sub nom., Arvey, Hodes, Costello & Burman v. Kline*, 513 U.S. 1032, 115 S. Ct. 613, 130 L. Ed. 2d 522 (1994); *In re Phillips Petroleum Secs. Litig.*, 881 F.2d 1236, 1244 (3d Cir. 1989) (citing *Angelastro v. Prudential-Bache Securities, Inc.*, 764 F.2d 939, 942-43 (3d Cir.), *cert. denied*, 474 U.S. 935, 106 S. Ct. 267, 88 L. Ed. 2d 274 (1985)).

Defendants McLeod, Forbes, and Shelton argue that plaintiffs have failed to adequately allege that the subject material misstatements were made in connection with the purchase or sale of ABI securities, that they reasonably relied on defendants' conduct, and that their injuries were proximately caused by defendants' conduct. Defendants McLeod and Forbes also argue that they owed no duty to purchasers of ABI securities. Defendant Cendant maintains that plaintiffs have failed to allege that the purported misrepresentations proximately caused them injury. Defendant E&Y insists that plaintiffs have not alleged that

the misrepresentations were made in connection with the purchase or sale of ABI securities and that plaintiffs have failed to plead facts giving rise to a strong inference of scienter on the part of E&Y. Finally, both defendants Cendant and E&Y assert that as a matter of law, plaintiffs could not have reasonably relied on any of their statements after April 15, 1998. Defendant Corigliano adopts the arguments of the other defendants generally, and in particular, the arguments that defendants owed no duty to purchasers of ABI securities and the alleged misstatements were not made in connection with the sale or purchase of ABI securities.

1. In Connection with the Purchase or Sale of Securities

According to these individual defendants and E&Y, plaintiffs have failed to state a § 10(b) claim in their complaints because they have not charged that defendants' purported misrepresentations were made in connection with the sale or purchase of ABI securities. Defendants Forbes, McLeod, and Corigliano further assert that they owed no duty to plaintiffs in the purchase or sale of ABI securities.

Defendants argue that because the misrepresentations plaintiffs have alleged do not pertain to the securities plaintiffs purchased or sold, they have failed to state a § 10(b) claim. As support, defendants rely on *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir. 1984), *cert. denied*, 469 U.S. 884, 83 L. Ed. 2d 190, 105 S. Ct. 253 (1984). There, Chemical Bank had extended loans to Frigitemp Corporation and its subsidiary, Elsters, Inc., which loans were partially secured by a pledge of Elsters stock. After Frigitemp and Elsters defaulted on the loans, Chemical Bank brought a § 10(b) and Rule 10b-5 claim against the accounting firm of Arthur Andersen based upon its preparation of allegedly false and misleading financial statements for Frigitemp but not for Elsters. Because the alleged misleading statements were not made in connection

with the pledge of Elsters stock, the court found that Chemical Bank had failed to state a claim for relief under § 10(b) and Rule 10b-5.

As the Third Circuit Court of Appeals announced in *Angelastro*, the law in this circuit "is not inconsistent with *Chemical Bank*." 764 F.2d at 946. *Angelastro* recognized the danger "in construing the 'in connection with' requirement so broadly that virtually any type of misconduct related to a securities transaction even in the most tenuous or tangential way might be claimed to give rise to a federal securities law violation." 764 F.2d at 945. Our circuit has cautioned trial courts to flesh out the proper scope of the "connection" requirement on a case-by-case basis to "avoid the pitfalls of overreaching." *Angelastro*, 764 F.2d at 945 (citing *Ketchum v. Green*, 557 F.2d 1022, 1027 (3d Cir.), *cert. denied*, 434 U.S. 940, 98 S. Ct. 431, 54 L. Ed. 2d 300 (1977). (1977)). Although the Supreme Court has concluded that § 10(b) must be read broadly to redress injuries which are the result of deceptive practices "touching" the purchase or sale of securities, *Superintendent of Life Insurance v. Bankers Life and Casualty Co.*, 404 U.S. 6, 12-13, 92 S. Ct. 165, 169, 30 L. Ed. 2d 128 (1971),[3] there must be a high degree of proximity of the securities transaction to the claimed fraud. *Ketchum*, 557 F.2d at 1027.

The securities transaction in *Bankers Life* was part of the defendants' fraudulent scheme. Bankers Life & Casualty Co. had agreed to sell all of the stock of the Manhattan Life Insurance Company ("Manhattan") to one of the defendants, Begole, for $5 million. Begole conspired with others and drew a check for the $5 million payment on an account at Irving Trust Co. ("Irving") although he then had no funds on

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[3] Some commentators have noted that Justice Douglas's use of the term "touching" was nothing "more than his variation of 'in connection with' as a matter of literary style." *Chemical Bank*, 726 F.2d at 942 (quoting Professor Loss, Fundamentals of Securities Regulation 903-904 (1983)).

deposit at that bank. Once Begole and his co-conspirators became stockholders and directors of Manhattan, they replaced Manhattan's board of directors with new members and convinced them to sell U.S. Treasury Bonds held by Manhattan for approximately $5 million. That sum was deposited in Begole's account at Irving to cover the check for the stock purchase. Begole and his co-conspirators then engaged in a complex series of transactions to conceal their misappropriation of Manhattan's funds. Thus, it is obvious that the defendants undertook the bond transaction in order to misappropriate the proceeds and acquire Manhattan's stock without any cost. In its analysis of *Bankers Life*, our circuit noted that the bond transaction itself was only one step away from the misappropriation. *Ketchum*, 557 F.2d at 1028.

By its *Ketchum* decision, the Third Circuit has concluded that where the claimed fraud is several steps away from the securities transaction, the relationship between the two is too attenuated to satisfy the "connection" requirement of § 10(b). 557 F.2d at 1027-1028. Defendant directors and officers of Babb, Inc. conspired to remove from office the *Ketchum* plaintiffs, who were two officers and employees of Babb as well as shareholders. This conspiracy included an alleged misrepresentation about the re-election of officers and directors. Once plaintiffs were removed from office, the board terminated them as employees as well. Pursuant to a stock retirement agreement which had been established many years earlier, plaintiffs were required to tender their shares to the corporation. Plaintiffs brought an action under § 10(b) and Rule 10b-5 against defendants on the theory that they were forced to tender their shares as a result of defendants' fraudulent scheme. The Court of Appeals found that the degree of proximity between the securities transaction, the forced stock sale, and the claimed fraud was too attenuated to satisfy the "connection" requirement of § 10(b). 557 F.2d at 1027-1028. Significantly, the court found that there were a "substantial number of intermediate steps between the fraud

and the accomplishment of the forced sale of plaintiffs' shares: the shareholders' vote subsequent to the misrepresentation; the ensuing meeting of the company directorate during which the plaintiffs were removed as officers; and the adoption of the resolution terminating the plaintiffs' status as company employees." 557 F.2d at 1028. These intermediate steps rendered the relationship between the fraud and the securities transaction too tenuous, too weak, to satisfy the "connection" requirement of § 10(b).

Similarly, the alleged misrepresentations here are many steps removed from plaintiffs' purchase of ABI securities. Plaintiffs allege that Cendant's false and misleading statements of its financial condition and intent to purchase ABI caused the artificial inflation of the price of ABI's shares and that the true value of the securities was substantially lower than the prices plaintiffs paid. The plethora of intermediate steps between Cendant's misrepresentations about its financial condition and plaintiffs' purchase of supposedly inflated ABI securities includes: the effect of AIG's offer to purchase ABI on the price of ABI stock; the ABI Board's decision to enter into a merger agreement with Cendant and end its merger agreement with AIG; the effect of the merger announcement on the price of ABI shares; the conditional nature of the merger agreement, that the agreement was terminable by the mutual consent of the parties with no resulting liability to either party or shareholders; the effect of Cendant's April and July announcements of accounting irregularities in its financial reports of earlier years; Cendant's affirmations of its intent to buy ABI; and the mutual termination of the merger by Cendant and ABI. The degree of proximity between the securities transaction and the claimed fraud, here, as in *Ketchum*, is too attenuated to meet the "connection" requirement of § 10(b). Cendant's alleged misrepresentations are too far removed from plaintiffs' purchase of ABI stock to support a cause of action under § 10(b).

A district court in our circuit has found that an alleged misrepresentation made by a tender offeror in conjunction with its tender offer was made in connection with a purchase or sale of securities. *In re Phillips Petroleum Securities Litig.*, 697 F. Supp. 1344 (D.Del. 1988), *vacated on other grounds*, 881 F.2d 1236 (3d Cir. 1989). On December 4, 1984, the Mesa Partnership ("Mesa") announced that it had acquired 5.7% of the outstanding stock of Phillips Petroleum Company ("Phillips") and that it would commence a tender offer for 15 million shares of Phillips common stock at $60 per share. At the same time, Mesa announced that it would not sell any Phillips shares back to Phillips except on an equal basis with all other Phillips shareholders. On December 5, 1984, Mesa filed a Schedule 13-D with the SEC which represented that the proposed tender offer was designed ultimately to obtain control of Phillips and iterated that MESA would not sell its shares back to Phillips except on an equal basis with other shareholders. After a series of negotiations with Phillips, Mesa withdrew the tender offer and sold its shares of Phillips stock to Phillips for $53 per share in cash even though Phillips did not offer to buy the stock of other shareholders at the same rate. Purchasers of Phillips stock during the period between December 5, 1984 and December 21, 1984, the day Mesa entered into negotiations for the buyback agreement with Phillips, sued Phillips and Mesa for violations of § 10(b) and Rule 10b-5, RICO, and various state laws. The district court found that Mesa's alleged misrepresentation in the tender offer that it would not sell its shares back to Phillips except on an equal basis with other shareholders, was made in connection with the purchase or sale of securities because it related to the purchase of securities by the class of Phillips shareholders and the pursuit of Phillips by Mesa. 697 F. Supp. at 1351 n. 10. The district court's grant of summary judgment to Mesa was vacated on other grounds. 881 F.2d 1236. The Third Circuit did not discuss the connection issue.

Our situation is unlike that in *Phillips* because there the alleged misrepresentation related directly to Mesa's sale of securities to Phillips and proposed acquisition of shares from other shareholders. As stated, the alleged misrepresentations here relate to Cendant's financial condition and not a sale back of stock. The degree of proximity between the misrepresentation and the purchase and sale of securities in *Phillips* was high whereas here it is too dissipated to satisfy the connection requirement.

2. Reasonable Reliance

All defendants argue that plaintiffs have failed to state a § 10(b) claim because they have not adequately alleged that they purchased ABI stock in reasonable reliance on defendants' conduct. Defendants contend that plaintiffs could not rely on any statement that the proposed merger would be completed because everyone in the securities market, including plaintiffs, was on notice that the proposed merger and tender offer were conditional. The merger agreement was subject to a number of conditions, particularly, that the transaction could have been renegotiated or terminated at any time by mutual consent of the boards of both companies. Thus, plaintiffs could not reasonably rely on Cendant's offer to purchase ABI stock at $67 per share.

According to defendants, Cendant's statements about its intent to buy ABI and complete the merger agreement were non-actionable forward-looking statements. Defendants maintain that these statements of intent must be viewed in light of the market's knowledge that the merger could be canceled at any time by the simple agreement of the parties.

Defendants also charge that at least until March 23, 1998, plaintiffs would have purchased or held ABI stock because they believed they would receive a price of $58 even if Cendant had not offered to buy ABI or misrepresented its financial condition. Until March 23, 1998, both AIG and

Cendant had offered to buy ABI at $58 per share. Plaintiffs argue that they purchased shares of ABI stock between January 27, 1998 and March 23, 1998 because they believed they would receive $58 per share and relied on the purported strength of Cendant's financial condition. The Court finds such argument to be legally deficient. That AIG had made an offer identical to Cendant's to buy ABI precludes the theory that Cendant's statements artificially inflated the price of ABI stock. Because plaintiffs could have purchased ABI stock with an expectation to receive $58, regardless of Cendant's offer and alleged misrepresentation, they cannot establish reliance.

Finally, plaintiffs could not have reasonably relied on Cendant's misrepresentations after April 15, 1998, because in its press release that day, Cendant specifically cautioned the public that its previously issued financial statements and auditors' reports should not be relied upon. Cendant announced that it would restate its financial statements for 1997 and possibly for other periods and that it would undertake an investigation into the accounting irregularities. Cendant warned that certain matters in the press release were forward-looking statements subject to a number of risks and uncertainties, including the investigation. Defendants insist that as a matter of law, there could be no reasonable reliance upon the April 15 announcement or on Cendant's earlier financial statements; that the statements in that press release cannot be the basis for a claim because of the "bespeaks caution" doctrine; and the statements in that press release are protected by the safe harbor provisions for forward looking statements in the Private Securities Litigation Reform Act ("PSLRA").

As a matter of law, plaintiffs could not have reasonably relied on defendants' alleged misrepresentations. Defendants' statements about the ABI merger and in the April 15 press release were forward-looking statements protected by the safe

harbor provisions of the PSLRA and bespoke caution. For the period between January 27 and March 23, 1998, plaintiffs could not have relied upon Cendant's representations for their belief that they would receive $58 per ABI share because AIG also offered the same price for ABI stock.

Under the PSLRA, a forward-looking statement may be, among other things,

> (A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;
>
> (B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer . . . .

15 U.S.C. § 78u-5(I). Once a statement is identified as a forward-looking statement, it is not actionable if it "is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." 15 U.S.C. § 78u-5(c)(1)(A).

Defendants' statements about the merger were forward-looking statements because they were plans for future operations. The statements in the April 15 press release were forward-looking because they focused on the estimated amount of restated earnings which ultimately depended on the investigation by the audit committee. Both the statements about the merger and those in the April 15 press release were accompanied by meaningful cautionary statements. With regard to the merger, the merger agreement was subject to several conditions and terminable at any time upon the simple agreement of the parties. In the case of the press release, the estimated amount of restated earnings was accompanied by a declaration that the restatement was subject to a number of

uncertainties including the outcome of the audit committee's investigation. These statements qualify for safe harbor treatment under the PSLRA.

The statements about the merger and those about the accounting irregularities also bespoke caution. The doctrine applies when language in an offering document negates the materiality of an alleged misrepresentation. The bespeaks caution doctrine is "shorthand for the well-established principle that a statement or omission must be considered in context, so that accompanying statements may render it immaterial as a matter of law." *In re Donald J. Trump Casino Securities Litigation*, 7 F.3d 357, 364 (3d Cir.), *cert. denied sub nom. Gollomp v. Trump*, 510 U.S. 1178, 114 S. Ct. 1219, 127 L. Ed. 2d 565 (1994). "In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law." 7 F.3d at 371. The cautionary language here, in the merger agreement, was sufficient because it explicitly warned that the merger might not be completed for any number of reasons, including the mutual agreement of the parties. The cautionary language in the April 15 press release was sufficient because it explicitly advised the public not to rely on any previous financial statements and that the full extent of the income and earnings restatements would depend on the outcome of the audit committee's investigation. Because of this cautionary language, plaintiffs could not reasonably rely upon any of these statements.

Plaintiffs' reliance on a "fraud on the market" theory does not satisfy the reliance and causation requirements of § 10(b). The Third Circuit has described the theory:

> The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . . Misleading statements

> will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

Peil v. Speiser, 806 F.2d 1154, 1160-1161 (3d Cir. 1986). Allegations of fraud on the market simply afford to plaintiffs a rebuttable presumption of reliance and causation so that each purchaser or seller need not individually prove these elements. *Basic Inc. v. Levinson*, 485 U.S. 224, 241-249, 108 S. Ct. 978, 992, 99 L. Ed. 2d 194 (1988). To invoke the presumption, a plaintiff must allege "1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and (5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed." *Basic*, 485 U.S. at 248, 108 S. Ct. at 992 (citing *Levinson v. Basic*, 786 F.2d 741, 750 (6th Cir. 1986)). "Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance." *Basic*, 485 U.S. at 248, 108 S. Ct. at 992. Assuming that plaintiffs have met the pleading requirements necessary to invoke the presumptions of the fraud on the market theory, the presumption of reliance has been rebutted.

3. Proximate Cause

Defendants Cendant, Forbes, McLeod, Shelton, and Corrigliano contend that plaintiffs have failed to state a § 10(b) claim because they have not alleged that the conduct by the defendants proximately caused their losses. Plaintiffs allege that Cendant's misstatements about its financial

condition caused Cendant to terminate the merger agreement with ABI and therefore caused their losses when Cendant failed to buy their ABI stock. Plaintiffs' theory of causation is that they purchased or held ABI stock in reliance on Cendant's misleading financial statements attached to the January and March 14D-1 filings, that defendants caused the overvaluation of ABI stock, that the revelation of Cendant's fraud caused the ABI stock price to drop, and they suffered damages because they had purchased ABI stock at inflated prices and the price then dropped. The loss plaintiffs suffered was due initially to the drop in ABI's stock price and later to Cendant's failure to complete the merger and buy their ABI stock at $67. Plaintiffs claim that had they known Cendant's true financial condition, they would not have purchased or held ABI stock.

Under the PSLRA, 15 U.S.C. 78u-4(b)(4), the plaintiff in a securities fraud action has "the burden of proving that the act or omission of the defendant alleged to violate [the securities laws] caused the loss for which the plaintiff seeks to recover damages." In order to state a § 10(b) claim, plaintiffs must allege both transaction causation and loss causation. *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir.1974), *cert. denied*, 421 U.S. 976, 95 S. Ct. 1976, 44 L. Ed. 2d 467 (1975); *see VT Investors v. R&D Funding Corp.*, 733 F. Supp. 823, 830 (D.N.J. 1990). To satisfy the transaction causation requirement, plaintiffs must establish that they would not have purchased or held ABI stock but for the defendants' misrepresentations. *Schlick*, 507 F.2d at 380. For loss causation, plaintiffs must allege that defendants' misrepresentations directly or proximately caused the economic losses incurred. *Schlick*, 507 F.2d at 380. Although the causation and connection requirements of § 10(b) are not the same, they are "closely intertwined." *Ketchum*, 557 F.2d at 1029 (citing *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187 (3d Cir. 1976)). They both "speak to the degree of proximity

required between a misrepresentation and a securities transaction." *Ketchum*, 557 F.2d at 1029.

Defendants argue that during the period between January 27 and March 23, 1998, Cendant's misrepresentations could not have caused the "artificial inflation" of ABI stock because AIG also set the value of ABI stock at $58. AIG independently determined the market price for ABI stock with its $58 offer based on its own evaluation of, and interest in, ABI, not the financial condition of Cendant. Defendants contend that the AIG offer constitutes an intervening cause of any purported harm suffered by plaintiffs as a result of their purchases of ABI stock at inflated prices. The Court takes the point of defendants. This intervening cause "serves to disrupt the connection between the challenged conduct on the part of the defendants" and plaintiffs' purchase or retention of ABI stock. *Ketchum*, 557 F.2d at 1029.

Defendants assert that their alleged misrepresentations were also not the cause of plaintiffs' losses due to the "artificial inflation" of ABI's stock price after March 23, 1998. Rather, the approval by the ABI Board of the merger agreement with Cendant constituted an independent, intervening cause for those losses. Defendants declare that the price of ABI shares reached a closing price as high as $64-7/16 on March 23, 1998 upon the approval of the ABI Board of the merger agreement with Cendant, not upon any statement or bid by Cendant.

Defendants also argue that the value of ABI shares depends on ABI's own financial statements, not those of Cendant. Defendants insist that Cendant's misstatements could not have caused plaintiffs' loss, because no matter how much Cendant's financial statements were misstated, if the tender offer and merger had been completed, the ABI shareholders would have received $67 a share. Had the tender offer and merger been consummated, plaintiffs would not have suffered any damages. The accounting irregularities could not have

had any effect on the value of Cendant shares ABI shareholders would have received in the merger because they would have received whatever number of Cendant shares was necessary to reach $67 in value. Plaintiffs allege that they bought or held ABI stock because they believed that they would receiver $58 or $67 per share. Because plaintiffs would have received $67 a share if the merger had taken place regardless of Cendant's accounting irregularities, there is no causal connection between defendants' financial misrepresentations and plaintiffs' losses from the fluctuation in ABI's stock price. So are the arguments of defendants.

The Court finds merit in defendants' arguments. Plaintiffs have not adequately alleged that defendants' misrepresentations caused the losses they incurred through, first the inflation of, then the decline in, ABI stock prices. There were several independent causes of plaintiffs' losses, but there is no causal connection between defendants financial misrepresentations and plaintiffs' losses. The "artificial inflation" of ABI's stock price was not caused by Cendant's misrepresentations. As said, before March 23, 1998, AIG had offered the identical price for ABI's stock as had Cendant. The price of ABI stock had reached its apex when ABI announced that it would forgo AIG's merger agreement for one with Cendant. Both the AIG offer and the announcement by the ABI board were independent causes of the inflation of ABI's stock. Moreover, plaintiffs' losses due to the decline in the price of ABI stock were not realized until ABI and Cendant announced, as they had every right to do, that the merger agreement had been terminated and that Cendant would not buy their ABI stock at $67. The termination of the merger, by the mutual consent of Cendant and ABI, was the proximate cause of plaintiffs' losses. The merger was abandoned because of the mutual agreement of the parties, not because of Cendant's misrepresentations.

Assuming the plaintiffs have met the pleading requirements necessary to invoke the presumption of causation of the fraud on the market theory, they still cannot satisfy the causation requirement of § 10(b) because the presumption has been rebutted inherently. The causation presumption is rebutted by a showing that the alleged loss was not the result of the alleged fraud. *Basic,* 485 U.S. at 248. Because there is no causal connection between defendants' alleged misrepresentations and plaintiffs' losses, the presumption of causation under the fraud on the market theory does not hold.

Another court has had before it similar litigation where shareholders who acquire stock of a corporation, the target of a tender offer, sue the prospective acquiring corporation for violations of § 10(b) and Rule 10(b)(5) after the offer is withdrawn. *In re ValueVision International Inc. Securities Litig.*, 896 F. Supp. 434 (E.D.Pa. 1995). The district court accepted, apparently without discussion, that the shareholders had standing to bring an action. However, *ValueVision* is easily distinguishable from our circumstances. There, ValueVision made a tender offer to purchase National Media Corporation ("National Media") and was unable to obtain the financing necessary to complete the merger. Plaintiffs were individuals who bought National Media stock during the pendency of the tender offer (the "purchaser class") and those who had tendered their National Media stock pursuant to the tender offer (the "tenderer class"). They alleged that the price of National Media stock was artificially inflated because of the investors' false impression that ValueVision would obtain financing and acquire National Media. Plaintiffs claimed that they relied on ValueVision's misrepresentations in purchasing and tendering National Media stock and that this reliance caused them injury because of the market's allegedly incorrect assessment of the value of National Media stock. The purchaser class asserted that ValueVision violated § 10(b) and Rule 10b-5, and the tenderer class claimed that

ValueVision violated § 14(e) of the Securities Exchange Act. The court held that the purchaser class had stated a claim under § 10(b) and Rule 10b-5 but that the tenderer class did not state a § 14(e) claim.

The misrepresentation in *ValueVision* related directly to ValueVision's ability to obtain financing. In contrast, Cendant's alleged misrepresentations did not concern any aspect of its merger with ABI or ability to finance the project. Moreover, ABI and Cendant mutually agreed to end the proposed merger without any resulting liability to either party or their shareholders. Cendant paid ABI $400 million. By contrast, ValueVision had agreed to pay National Media a $7 million break-up fee if it terminated the merger agreement, but later refused to pay the amount. And, the alleged misrepresentations here, unlike those in *ValueVision*, did not proximately cause plaintiffs' losses or the termination of the merger agreement.

Plaintiffs have failed to state a cause of action under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) because they have not adequately plead connection, reliance, or causation.

C. Section 14(e) of the Securities Exchange Act of 1934

In 1968, Congress amended the Securities Exchange Act of 1934 by the Williams Act to protect investors who are confronted with a tender offer for their stock. *See Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 35, 97 S. Ct. 925, 946, 51 L. Ed. 2d 124 (1977). Section 14(e) of the Williams Act, 15 U.S.C. § 78n(e) makes it:

> unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in

> connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

The statute itself does not explicitly provide for a private right of action to enforce § 14(e). In *Piper*, the Supreme Court expressly reserved decision on the issue of whether a corporation which is the target of a tender offer or its shareholders have an implied cause of action under § 14(e). 430 U.S. at 42 n.28, 97 S. Ct. at 949 n. 28. The Court announced, however, that a tender offeror, suing in its capacity as a takeover bidder, does not have standing to sue for damages under § 14(e). 430 U.S. at 38, 42 n.28, 97 S. Ct. at 947-948, 949 n. 28.

Various circuit courts have permitted a private cause of action under § 14(e) in certain contexts. The First, Second, and Third Circuits have held that a corporation which is the target of a tender offer has standing under § 14(e) to sue the tender offeror for injunctive relief. *Polaroid Corp. v. Disney*, 862 F.2d 987 (3d Cir. 1988); *H.K. Porter Co., Inc. v. Nicholson File Co.*, 482 F.2d 421 (1st Cir. 1973); *Gulf & Western Industries, Inc. v. Great Atlantic & Pac. Tea Co., Inc.*, 476 F.2d 687 (2d Cir. 1973). The Third and the Fifth Circuits have held that shareholders of a target corporation have a private right of action under § 14(e) to sue the tender offeror corporation. *Polaroid*, 862 F.2d 987 (recognizing a private remedy "to enable injured shareholders to seek damages to compensate for loss stemming from violation of the Act and an injunction against a tender offer violating the Act where the requirements for equitable relief have been met"); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th

Cir.), *cert. denied*, 419 U.S. 873, 95 S. Ct. 134, 42 L. Ed. 2d 113 (1974) (allowing a shareholder of a corporation which merged with another corporation to bring suit against the two corporations under § 14(e)).

The elements of a § 14(e) claim are virtually identical to those of a § 10(b) claim. *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973), *cert. denied*, 414 U.S. 910, 94 S. Ct. 232, 38 L. Ed. 2d 148 (1973). The difference between them is that the material misstatements in a § 14(e) claim must be made "in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation," while a § 10(b) claim requires a connection with a purchase or sale of securities. 15 U.S.C. § 78n(e).

1. Reliance

Defendants have argued that plaintiffs fail to state a § 14(e) claim because they have not adequately alleged reliance. Defendants maintain that plaintiffs have no claim under § 14(e) as a matter of law because Cendant's tender offer was never completed. To state a § 14(e) claim, plaintiffs must allege that they relied on defendants' misrepresentations in making their decision to tender or not to tender their shares. Because there is no allegation that plaintiffs relied on defendants' misrepresentations to make their decision to tender, plaintiffs have failed to state a § 14(e) claim.

Shareholders of a target corporation who claim reliance and injury outside their decisions to tender cannot state a claim under § 14(e). As the Third Circuit has recognized, § 14(e) "was not intended to create a federal cause of action for all harms suffered because of the proffering or the withdrawal of tender offers. Rather, § 14(e) was enacted principally as a disclosure statute, designed to insure that fully-informed investors could intelligently decide how to

respond to a tender offer." *Schreiber v. Burlington Northern, Inc.*, 731 F.2d 163, 165-166 (3d Cir. 1984), *aff'd.* 472 U.S. 1, 4-5, 105 S. Ct. 2458, 2460-2461, 86 L. Ed. 2d 1 (1985). Where, as here, the tender offer was not completed, plaintiffs have not alleged that the misrepresentations affected their decision to tender, they have not claimed reliance, plaintiffs have failed to state a cause of action under § 14(e). *See, e.g., Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092, 70 L. Ed. 2d 631, 102 S. Ct. 658 (1981) (where a tender offer was withdrawn before plaintiffs had the opportunity to decide whether to tender their shares, it was impossible for plaintiffs to rely on any alleged deception in making their decision to tender); *Lewis v. McGraw*, 619 F.2d 192, 195 (2d Cir.), *cert. denied*, 449 U.S. 951, 66 L. Ed. 2d 214, 101 S. Ct. 354 (1980) (where no tender offer was consummated, no reliance was possible under any imaginable set of facts). Although both *Panter* and *Lewis* involved tender offers which were withdrawn before they became effective, the Court finds that their reasoning applies to these circumstances, where the tender offer was withdrawn before its expiration and before the acquiring corporation purchased any shares.

Even *ValueVision* found that those plaintiffs who had tendered their National Media shares did not state a § 14(e) claim because the tender offer was never completed. 896 F. Supp. at 439. There, as here, the acquiring corporation was never obligated to purchase the tendered shares, and the shareholders of the target corporation were always free to withdraw the tenders before the expiration of the tender offer. 896 F. Supp. at 439 (citing 17 C.F.R. § 240.14d-7(a)). Although plaintiffs alleged at oral argument that they tendered shares before the offer was withdrawn, those tenders were not successful or definitive. Plaintiffs could have withdrawn the tenders at any time before the expiration of the tender offer pursuant to SEC rule 14D-7(a), 17 C.F.R.

§ 240.14d-7(a), and Cendant did not purchase, nor was it obligated to purchase, any of those tendered shares.

Most importantly, plaintiffs' claim is that they were induced to purchase or hold shares of ABI stock in reliance on alleged misrepresentations found in the tender offer, not that they were induced to tender or not tender their shares in reliance on those misrepresentations. Plaintiffs have not claimed that they relied on supposed misrepresentations to decide to tender or not to tender their shares. Plaintiffs have failed to state a claim for relief under § 14(e) because they have failed to allege reliance.

2. Causation

Plaintiffs have also failed to plead that defendants' misrepresentations caused their injuries. Even if plaintiffs had charged that they relied on defendants' misrepresentations to make their decision to tender their shares and were damaged when Cendant did not purchase their tendered shares, they could not claim that those misrepresentations caused their injuries: The termination of the merger agreement and tender offer, by the mutual consent of the Cendant and ABI boards, caused their injuries. Plaintiffs' § 14(e) claim fails because plaintiffs have not adequately plead reliance or causation.

D. Section 20(a) of the Securities Exchange Act of 1934

Section 20(a) creates liability for "controlling persons" in a corporation, 15 U.S.C. § 78t(a), and imposes joint and several liability upon anyone who "controls a person liable under any provision of" the Securities Exchange Act of 1934. To maintain a claim, the plaintiffs must establish (1) an underlying violation by a controlled person or entity, (2) that the defendants are controlling persons, and that they were "in some meaningful sense culpable participants in the fraud perpetrated by controlled persons." *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880, 885 (3d Cir.1975) (citation omitted).

Plaintiffs charge that defendants Forbes, Shelton, Corigliano, and McLeod were controlling persons of Cendant. Plaintiffs contend that each defendant, by virtue of his position as an executive officer or director of CUC and Cendant, exercised his power and influence to cause Cendant and the other individual defendants to violate §§ 10(b) and 14(e) of the Securities Exchange Act of 1934 and Rule 10b-5. Plaintiffs cannot maintain an action against the individual defendants under § 20(a), because they have failed to establish an underlying violation of the securities laws by Cendant.

E. Plaintiffs' Motion for Leave to Amend

Plaintiffs have requested leave to amend their complaints if any or all of their claims are dismissed. However, plaintiffs have not detailed the substance of any amendment or presented to the Court a proposed amended complaint. Although plaintiffs no longer have the right to amend their complaints as a matter of course after those complaints have been dismissed, the Court may still permit amendment as a matter of discretion. *Kauffman v. Moss,* 420 F.2d 1270, 1276 (3d Cir.), *cert. denied*, 400 U.S. 846, 91 S. Ct. 93, 27 L. Ed. 2d 84 (1970). However, the Court will not consider plaintiffs' requests until they submit the sought amendment for the Court's review. The present complaints lack legal vitality. Without scrutiny of the proposed amendment, the Court cannot determine whether it, the amendment, would be resuscitable or futile. Plaintiffs' motion for leave to amend is denied.

CONCLUSION

Because plaintiffs have failed to state a cause of action under §§ 10(b), 14(e), and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5, the motions to dismiss by all defendants are granted. Plaintiffs' motion for leave to amend their complaints is denied.

SO ORDERED:

ORDER

This matter comes before the Court on the motion of all defendants to dismiss plaintiffs' amended complaints for failure to state a claim upon which relief may be granted, and upon plaintiffs' motion for leave to amend their complaints if any of their claims are dismissed. Upon consideration of the submissions of the parties, oral argument, and for the reasons stated in the accompanying opinion,

It is on this 30th day of April, 1999,

ORDERED that the motions of all defendants to dismiss plaintiffs' complaints are granted; and

ORDERED that plaintiffs' motion for leave to amend their complaints is denied.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

[Filed 9-14-00]

Nos. 99-5355/5356

GEORGE SEMERENKO

vs.

CENDANT CORP., *et al.*

SUR PETITION FOR REHEARING

Present: BECKER, *Chief Judge*, SLOVITER, MANSMANN, SCIRICA, NYGAARD, ALITO, ROTH, MCKEE, RENDELL, BARRY, AMBRO, FUENTES and ALARCON,* *Circuit Judges*.

The petition for rehearing filed by appellee in the above entitled case having been submitted to the judges who participated in the decision of this court and to all other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

BY THE COURT,

/s/ Carol Los Mansmann
Circuit Judge

SEP 14, 2000

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* The Honorable Arthur L. Alarcon voted only as to panel rehearing.

APPENDIX D

15 U.S.C. § 78j (2000)

It shall be unlawful for any person, directly, or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

17 C.F.R. 240.10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.